(ii) authorises another person to take a conveyance of immovable property that is subject to the other instrument;

except where a nomination is made, or a direction is given, in favour of a person who is to be a trustee for the purchaser or who is a parent, spouse or child of the purchaser.

'Unwritten sale agreement' is defined in s.29A(1) to mean a contract, agreement, or statement not in the form of an instrument but of such a nature that, if it were in such a form, the instrument would constitute an AFS.

The requirement that an instrument be executed applies whether an AFS is enforceable or unenforceable, absolute or conditional, formal or informal, temporary or permanent, provisional or non-provisional (s.29A(2)). In this connection, the requirements of Part IIIA can hardly be avoided or circumvented. However, the Chief Executive is empowered to remit or refund stamp duty in cases where it is just and equitable to do so.

When an unwritten sale agreement or an AFS has been made, each vendor and purchaser under the agreement must execute an AFS containing the matters specified in s.29B(5) no later than thirty days after the date on which the unwritten sale agreement or an AFS was made (s.29B(1)).

Any person who is required to execute an AFS but fails to do so is civilly liable for the amount of stamp duty chargeable on that agreement, which will be deemed to be chargeable whether or not it is in respect of residential property (s.29B(6)). If two or more persons fail to execute such an agreement, each person is jointly and severally liable.

3.2.2 Rates of stamp duty

The rate of stamp duty for an AFS of residential property under Head 1(1A) is the same as that for a conveyance on sale of non-residential property under Head 1(1) (refer to the table of ad valorem rates in **section 3.1**).

As with the conveyance on sale, Part IIIA contains an anti-avoidance provision (s.29G). If a duty-payer wishes to enjoy the progressive rates rather than the maximum rate of 4.25%, he or she must include in the AFS a s.29G certificate stating that the transaction does not form part of a larger transaction or a series of transactions, in respect of which the aggregate consideration or value exceeds the amount for that progressive rate.

If stamp duty has already been imposed on an AFS (a provisional AFS or a formal AFS if it is executed within 14 days of signing the provisional AFS) of residential property, stamp duty payable on the conveyance on sale of the residential property which is executed in conformity with, or pursuant to, the duly stamped AFS, is $100: s.29D(2)(a). The table below summaries the charge of stamp duty for transfer of immovable property:

	Purchase/sale of residential property	Purchase/sale of non-residential property
Provisional (Temporary) AFS	Ad valorem stamp duty under Head 1(1A), or nil if a formal AFS is executed within 14 days	No stamp duty
Formal AFS	$100, or ad valorem stamp duty under Head 1(1A) if the formal AFS is executed within 14 days	No stamp duty
Conveyance (Assignment)	$100, or ad valorem stamp duty under Head 1(1) if the conveyance is not executed in conformity with a duty stamped AFS	Ad valorem stamp duty under Head 1(1)

In addition to the *ad valorem* rates, an AFS may be subject to SSD (Head 1(1B)) for residential property acquired by a vendor on or after 20 November 2010 and resold within 24 months (see **section 3.3** for details on SSD).

Example 9

J sold a residential property to K for a consideration of $9 million. The provisional AFS was signed on 1 May 2013, the formal AFS was signed on 13 May 2013, and the deed of assignment was signed on 1 June 2013.

The provisional AFS is chargeable under Head 1(1A). However, since it is superseded by the formal AFS subsequently signed on 13 May 2013 (within 14 days of signing the provisional AFS), the formal AFS becomes the chargeable instrument. The stamp duty payable will be 3.75% on $9 million, i.e. $337,500. The deed of assignment will then be subject to stamp duty of $100.

3.2.3 Series of AFS

In the case of a series of AFS between different parties for the same residential property, stamp duty is chargeable on each of the AFS and the conveyance on sale, resulting in additional costs to the property speculators.

The Stamp Office will pass the information about the speculators to their colleagues in the IRD to consider imposing profits tax on the speculative gains.

Example 10

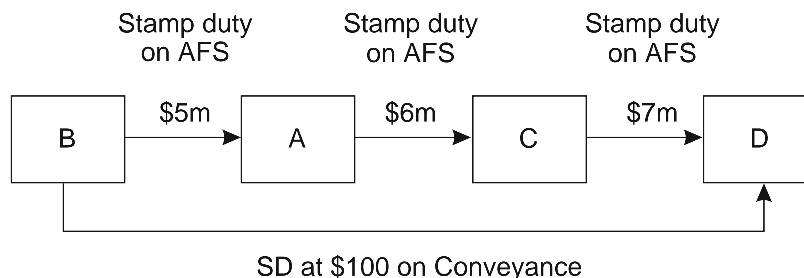
A acquired a property from B at $5 million and sold it to C for $6 million. C then sold the property to D for $7 million. The property was finally conveyed from B to D. Stamp duty will be imposed on:

(a) the AFS between B and A, based on the consideration of $5 million at 3%;

(b) the AFS between A and C, based on the consideration of $6 million at 3%; and

(c) the AFS between C and D, based on the consideration of $7 million at 3.75%.

Stamp duty payable on the conveyance on sale between B and D executed in conformity with the duly stamped AFS will be $100.

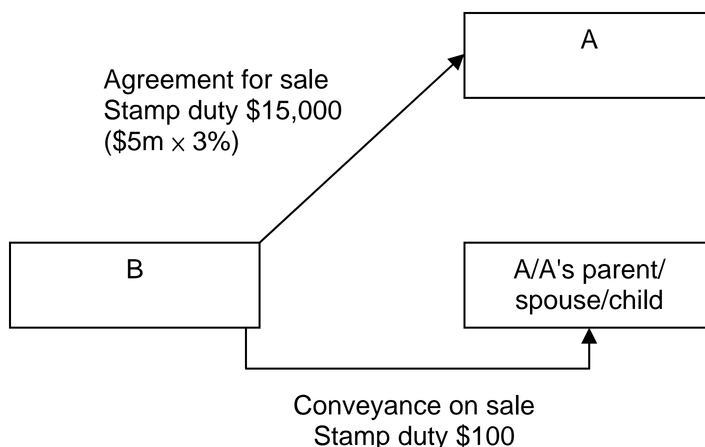


Based on the information provided by the Stamp Office, the IRD will raise enquiries on A and C. If there are badges of trade indicating that A and C are trading in properties, they will have to pay profits tax on their trading gains on disposal of the property.

Further ad valorem stamp duty is payable if a name is added to or deleted from an AFS. The stamp duty payable is proportional to the share of the ownership change under s.29D(4) and (5). However, a parent, spouse or child of the purchaser will be regarded as the same person as the purchaser (Note 5 to Head 1(1A)); and no further duty is payable.

Example 11

A signed an AFS to purchase a residential property from B at $5 million, and stamp duty on the AFS was charged at 3% on $5 million. On conveyance, A admitted his parent, spouse and child as joint tenants of the property. In such circumstances, the stamp duty chargeable on conveyance will be $100 as A's parent, spouse and child are deemed to be the same person as A.



If, instead of admitting his parent, spouse and child, A admitted his brother and sister as joint tenants, further *ad valorem* duty will be payable on the conveyance on sale in the amount of $100,000 ($5 million × 3% × 2/3).

3.2.4 AFS involving residential and non-residential properties

A single AFS may involve both residential and non-residential units. According to SOIPN 1, the Collector's practice is as follows:

(a) The AFS is regarded as an AFS of a residential property and the whole consideration is liable to stamp duty.

(b) Stamp duty may be computed on the consideration for the residential units only, provided that:

  (i) the residential and non-residential units are separate and distinct properties; and

  (ii) the respective considerations for the residential and non-residential units are separately set out in the AFS.

The stamp duty rate applicable will still be based on the total consideration for the whole transaction.

3.2.5 Deferring payment of stamp duty on AFS

Before 1 April 1999, a rescinded AFS was normally chargeable with stamp duty. Relief for stamp duty may only be granted for an AFS that was rescinded because the vendor was unable to prove his or her title. Since 1 April 1999, an AFS that is cancelled, annulled or rescinded or is otherwise not performed will not be regarded as a chargeable AFS (s.29C(5A)(a)); and stamp duty will not be chargeable provided that the AFS is not rescinded under an arrangement for re-selling the property by the purchaser (s.29C(5A)(b)).

If stamp duty has been paid for an AFS which is not regarded as a chargeable AFS, an application for refund may be made to the Collector within two years after the cancellation, annulment or rescission of the AFS; or in the case where the AFS is not performed, two years after the agreed date of completion of the transaction (s.29C(5B)).

With the anti-speculation provisions, stamp duty payable on residential property transfers is no longer deferred until a conveyance on sale is finally executed. However, from 1 April 1999 onwards, duty-payers may apply to defer payment of stamp duty until completion of the purchase, or in the case where the property is sub-sold, the making of the sub-sale agreement. Nevertheless, starting from 1 April 2010, chargeable AFS of residential property valuing over $20 million is not eligible for the deferred payment application. Furthermore, with effect from 30 June 2011, deferral of stamp duty is no longer applicable to chargeable AFS for residential properties valued at $20 million or below.

SOIPN 1 (Revised) may be referred to for other examples of transactions involving the sale of residential property.

3.3 Special stamp duty (Head 1(1AA) and 1(1B))

To further discourage speculation in residential properties, a SSD would be imposed on the disposal of residential properties which were acquired by an individual or a company (regardless of where it is incorporated) on or after 20 November 2010 and resold within 24 months from the date of acquisition. It is imposed on top of the ad valorem duty on a chargeable AFS of residential property under s.29CA and Head 1(1B); or a conveyance on sale under s.29DA and Head 1(1AA), with a few exemptions available.

SSD is a duty imposed on residential property transactions, not a charge on the gain on sale of the property. If the sale of property constitutes a trade, the seller will still be subject to profits tax on the profits earned, but the SSD is a tax deductible expense.

3.3.1 Rates of SSD

Conveyance on sale or AFS is chargeable with SSD under Head 1(1AA) and (1B). The seller and the buyer are jointly and severally liable for paying the SSD which is calculated based on the stated consideration or the market value, whichever is the higher, of the resold property at the following regressive rates, with higher rates for shorter holding periods:

Holding period	Duty rate
≤ 6 months	15%
> 6 months but ≤ 12 months	10%
>12 months but ≤ 24 months	5%

3.3.2 Counting of the holding period

In counting the holding period, a person 'acquires' a residential property when equitable ownership or legal ownership of the property is passed to the person. A person 'disposes of' a residential property when equitable ownership or legal ownership of the property passes from the person to another person. The dates of acquisition and disposal of a property is based on the signing date of the chargeable AFS, or if no such chargeable AFS exists, the signing date of conveyance (i.e. assignment). For the purpose of determining the date of acquisition or disposal, it is provided that:

(a) where there are more than one chargeable AFS between the same parties and on the same terms, the signing date of the earliest AFS will be taken as the date of acquisition or disposal of the property.

(b) where a chargeable AFS or conveyance consists of two or more instruments, a principal instrument and supplemental instrument(s), the date of the first of those instruments is regarded as the date of acquisition or disposal.

For SSD purposes, the counting of the holding period of a residential property is based on calendar months. The period from a certain day in a month to the preceding day in the following calendar month is counted as one month. If there is no corresponding preceding day in the relevant subsequent month, the month calculation ends on the previous available day of that month.

For example, the period from 30 January 2013 to 28 February 2013 is one month, since the date of '29 February 2013' does not exist.

Example 12 (Adapted from SOIPN 5, Examples 2 to 5)

Mr Ho acquired a residential property on 10 September 2011 and disposes of it for $6.5 million on:

(a) 9 March 2012;

(b) 10 March 2012;

(c) 18 March 2013; or

(d) 30 November 2013.

How is the holding period of the property calculated? What is the rate of SSD and what is the amount of SSD payable?

Solution

As the subject property was acquired after 19 November 2010, SSD will apply if the property is sold within 24 months from the date of acquisition. For SSD purposes, the property holding period is calculated based on the calendar months, i.e. the period from a certain day in a month to the preceding day in the following calendar month is counted as one month.

(a) In this case, Mr. Ho has held the property for exactly 6 months. The applicable rate of SSD is 15%. The amount of SSD payable is $975,000 ($6.5 million × 15%).

(b) In this case, Mr. Ho has held the property for more than 6 months but not more than 12 months. The applicable rate of SSD is 10%. The amount of SSD payable is $650,000 ($6.5 million × 10%).

(c) In this case, the property was disposed of for more than 12 months but within 24 months from the date of acquisition. The applicable rate of SSD is 5%. The amount of SSD payable is $325,000 ($6.5 million × 5%).

(d) In this case, the property was disposed of after 24 months from the date of acquisition. Therefore, no SSD is payable.

A person 'acquires' a property if he enters into a specifically enforceable AFS of that property. For SSD purposes, a provisional AFS is a chargeable AFS. The buyer who entered into a provisional AFS of a residential property before 20 November 2010 is regarded as having 'acquired' the property before that date, and SSD will NOT apply to the disposal of the property even if it is made within 24 months from the date of acquisition.

Example 13 (Adapted from SOIPN 5, Example 1)

Mr. Chiu signed a provisional AFS to acquire a residential property on 15 September 2010. Subsequently, he signed a provisional AFS to dispose of the property on 20 December 2010.

As Mr. Chiu acquired the subject property before 20 November 2010 (the effective date of SSD), no SSD is payable when he signed the provisional AFS to dispose of the property on 20 December 2010.

3.3.3 Exchange or partition of residential properties

The agreement for exchange or partition of residential properties is in essence an AFS. The date of signing it is regarded as the date of 'acquisition' or 'disposal' of the properties concerned; and SSD is calculated by reference to the 'equality money' payable for the exchange or partition (s.29C(10)). Where the stated 'equality money' under an agreement for exchange or partition is less than the full difference in the values of the properties concerned, SSD is charged on the full difference: s.29F.

If the dates of acquisition of the exchanged properties by the respective parties in the exchange are different, the earlier one will be taken for counting the holding period. Where a residential property is exchanged for a non-residential property, only the date of acquisition of the residential property in the exchange is relevant for counting the holding period.

Example 14 (Adapted from SOIPN 5, Scenario 5)

Mr. X acquired a residential property A on 1 January 2013. Later, Mr. Y acquired a residential property B on 1 July 2013. On 30 September 2013, they executed an agreement for exchange with equality money being $1 million.

For the purpose of counting the holding period, the date of acquisition of property A (1 January 2013) which is earlier is taken. The holding period (from 1 January 2013 to 30 September 2013) is therefore more than 6 months but less than 12 months. The applicable SSD rate is 10%, and thus the amount of SSD payable is $100,000 ($1 million × 10%).

Example 15 (Adapted from SOIPN 5, Scenario 6)

Facts are the same as in Example 14, except property A was a non-residential property.

For the purpose of counting the holding period, the date of acquisition of the residential property, property B (1 July 2013) is taken. The holding period (from 1 July 2013 to 30 September 2013) is therefore less than 6 months. The applicable SSD rate is 15%, and thus the amount of SSD payable is $150,000 ($1 million × 15%).

3.3.4 Time for payment of SSD

Heads 1(1AA) and (1B) stipulate that a chargeable instrument is to be stamped with SSD at the same time as that for the ad valorem stamp duty, i.e. in general, within 30 days after the date on which the AFS is entered into or the conveyance is executed.

The provisions in relation to SSD are effective from 20 November 2010. In respect of AFS executed between 20 November 2010 and the date on which the new law comes into force (30 June 2011), any SSD has to be paid within 30 days of that date: s.68.

Where a residential property acquired by the seller on or after 20 November 2010 is disposed of or transferred on or after 30 June 2011 and the holding period of the property is within 24 months, SSD is payable within 30 days after the date of signing the chargeable AFS. If there is no chargeable AFS, SSD is payable within 30 days after the date of the conveyance.

Furthermore, deferred payment of stamp duty will not be granted for chargeable AFS of residential property, even if valued at or below $20 million (effective 30 June 2011).

3.3.5 Persons liable to pay SSD

The vendor and the purchaser to the residential property transaction are jointly and severally liable for paying the SSD. Heads 1(1AA) and (1B) provide that all parties to the instruments chargeable with SSD, i.e. a chargeable AFS and a conveyance on sale, and all other persons executing the instruments are liable to pay the SSD.

However, signing the chargeable instruments in the capacity of witness (e.g. estate agents or solicitors) will not render a person becoming one of the liable persons. On the other hand, a person who uses such an instrument may be liable to pay the SSD, e.g. an estate agent suing the vendor/purchaser for the agency fee based on a provisional AFS.

3.3.6 Refund of SSD

If a chargeable AFS is cancelled, annulled or rescinded or is otherwise not performed (not because of the occurrence of a further resale as described in s.29C(5AA)), an application for refund of SSD can be made to the Collector within two years after the cancellation, annulment or rescission of the

AFS, or in the case where the AFS is not performed, two years after the agreed date of completion of the transaction. Likewise, an application for refund of the SSD on conveyance on sale can be made to the Collector within two years after the conveyance on sale is cancelled in accordance with s.48.

3.3.7 Exemptions from SSD

Payment of SSD is exempted in the following cases (ss.29CA and 29DA):

(a) Nomination of a close relative (a parent, spouse, child, brother or sister) to take up the assignment of a residential property under an AFS (i.e. the assignment is treated as "in confirmatory with" an AFS). The IRD has indicated that it will accept persons who are blood-related, half-blood related, adopted or step-related (SOIPN 5, para 32(a));

(b) Sale or transfer of a residential property to a close relative;

(c) Addition/deletion of a name to/from a chargeable AFS or a conveyance on sale of a residential property if the person is a parent, spouse, child, brother or sister of the original purchaser;

(d) Sale, transfer or vesting of a residential property made by the courts or pursuant to a court order (including a compulsory sales order made under the Land (Compulsory Sale for Redevelopment) Ordinance, and a foreclosure order made to a mortgagee, irrespective of whether the mortgagee is a FI within the meaning of s.2 of the IRO), and the residential property was sold to/transferred to or vested in the seller by or pursuant to any decree or order of any court;

(e) Sale or transfer of a residential property that relates to the estate of a deceased person, and sale or transfer of a residential property by a person whose property is inherited from a deceased person's estate or is passed to that person under the right of survivorship;

(f) The residential property sold relates solely to a bankrupt's estate or the property of a company which is being wound up by the court by reason of its inability to pay debts;

(g) Sale of mortgaged properties by a mortgagee which is a FI within the meaning of s.2 of the IRO, or by a receiver appointed by such a mortgagee;

(h) Sale or transfer of a residential property to the Government; and

(i) Sale or transfer of a residential property between associated bodies corporate.

It should be noted that under the above circumstances, only the payment of SSD is exempted; the underlying AFS or transfers remain chargeable AFS or transfers under which the purchasers or transferees 'acquired' the immovable properties. When the properties are further disposed of subsequently, any SSD liability will be determined by reference to such 'acquisition' dates (SOIPN 5, para 33).

Moreover, SSD does not apply to the sale of first-hand residential properties. Therefore, the following sale or transfer is not chargeable to SSD:

(a) Sale or transfer of residential units built on a bare site, regardless of whether the bare site has been acquired by the developer from the Government or from another developer;

(b) Sale or transfer of redeveloped residential units after demolition of the original properties acquired;

(c) Sale or transfer of a bare site after demolition of the original properties acquired; and

(d) Sale or transfer of a bare site acquired from the Government to another developer.

SOIPN 5 (Revised) provides guidance on the imposition of SSD.

3.4 Lease (Head 1(2))

A 'lease' refers to a grant of the possession of property for a term of years, either a fixed period or a term not defined or uncertain, from the lessor to the lessee in consideration of a premium or rent or both a premium and rent.

The charge under Head 1(2) only covers leases of immovable property. Lease agreements for hiring of chattels such as cars, machines, ships, etc are not chargeable to stamp duty.

To constitute a lease, the instrument must give the tenant the right to exclusive possession. If the right of the tenant is restricted, e.g. the right of a hotel guest, the instrument is a licence rather than a lease. A licence is not chargeable to stamp duty. Whether an instrument is to be construed as a licence or a lease shall depend on the substance of the transaction rather than its form.

In general, the stamp duty on a lease of immovable property is shared by the landlord and tenant equally. However, it is prudent to ascertain who will bear this cost before the transaction is agreed.

3.4.1 Lease with premium only (Head 1(2)(a))

A lease premium covers release of a debt, lump sum payment on a contingency, allotment of shares, etc. A lump sum paid to obtain a lease is a premium: *Miramar Hotel & Investment Co Ltd & Lane Crawford v CSR*. A premium represents the capital value of the difference between the actual rent and the best rent that otherwise might be obtained: *The HK Garage Ltd & Lane Crawford v CSR*. It is the practice of the Stamp Office to treat an advance payment of more than one year's rent as a premium.

For a lease with premium only, stamp duty is levied at the same rate as that under Head 1(1) for a conveyance on sale (i.e., $100 or 0.75 – 4.25%).

3.4.2 Lease with premium and/or rent (Head 1(2)(b))

For a lease with a consideration comprising both a premium and/or rent,

(a) the premium will be charged with stamp duty at 4.25%, the same rate as the maximum rate for a conveyance on sale; and

(b) the rent will be charged with stamp duty by reference to the term of the lease agreement and the amount of yearly or average yearly rent as follows:

Term of lease	Stamp duty
Not defined or uncertain	25 cents for every $100 or part thereof of the yearly or average yearly rent (i.e. 0.25%)
≤ 1 year	25 cents for every $100 or part thereof of the total rent payable over the term of the lease (i.e. 0.25%)
> 1 year but ≤ 3 years	50 cents for every $100 or part thereof of the yearly or average yearly rent (i.e. 0.5%)
> 3 years	$1 for every $100 or part thereof of the yearly or average yearly rent (i.e. 1%)

Note: Rent-free period is taken as part of the lease period for the purpose of determining the lease period.

Example 16

L let his shop to M for three years at an agreed premium of $50,000 and a monthly rent of $25,000 for the first year. Thereafter, the monthly rent will be increased to $30,000 for the second year, and $35,000 for the third year.

The lease agreement is dutiable under Head 1(2)(b). As the term of the lease is three years, the stamp duty payable is 4.25% of the premium and 0.5% of the average yearly rent. Stamp duty payable is $3,925 [($50,000 × 4.25%) + ($300,000 + $360,000 + $420,000)/3 × 0.5%)].

Example 17

N Ltd enters into an agreement to lease machinery from P Inc, a company incorporated and carrying on business in the US, at a monthly rental of $30,000.

The lease agreement for the machinery does not fall within any of the charging heads and is not chargeable to stamp duty.

As P Inc does not carry on any business in Hong Kong, the rental income from lease of the machinery is not chargeable to profits tax under s.14 of the IRO. It is, however, a deemed trading receipt chargeable to profits tax under s.15(1)(d) of the IRO.

3.4.3 Contingency Principle

As explained in **section 2.3.8**, no stamp duty is assessed if the consideration is uncertain at the time of execution.

However, if the maximum or minimum amount of rent payable is stated in the lease agreement, stamp duty will be assessed on the maximum amount (or the minimum amount if the maximum monthly rental is not stated).

Example 18

Q Ltd enters into an agreement to lease a property from R Ltd, its wholly owned subsidiary, for a term of five years. Under the lease agreement, Q Ltd will pay 1% of the gross revenue from its operations to R Ltd as lease rental, subject to a maximum of $100,000 per annum. The gross revenue from its operations is expected to be around $8 million per annum for the next few years.

The proposed lease agreement for the property is dutiable under Head 1(2)(b). As the term of the lease is over three years, stamp duty payable is 1% of the annual rent. Since the annual rent depends on the gross annual revenue subject to a maximum of $100,000, the sum of $100,000 is used to determine the stamp duty payable, which is $10,000 ($100,000 × 1%).

Although Q Ltd and R Ltd are associated bodies corporate under s.45, the s.45 relief is not applicable to lease agreements (see **section 8.2** on 'Relief under s.45').

3.4.4 Lease executed in pursuance of a duly stamped agreement for lease (Head 1(2)(c))

The stamp duty payable on a lease executed in pursuance of a duly stamped agreement for lease is $3.

4 Hong Kong Stock (Head 2)

Topic highlights

The stamping of Hong Kong stock is governed by Head 2 in the First Schedule:

Head 2 Hong Kong stock
- **2(1)** Contract note
- **2(2)** Contract note (jobbing business)
- **2(3)** Transfer as voluntary disposition
- **2(4)** Transfer of any other kind

'Stock' is defined in s.2(1) to include the following investments:

(a) any shares, stocks, debentures, loan stocks, funds, bonds or notes etc;

(b) any units under a unit trust scheme; and

(c) any rights to subscribe for any stock (excluding employees' share options).

Stock, in general, does not include any loan capital, or any bill of exchange or promissory note, or any certificate of deposit or any Exchange Fund debt instrument or Hong Kong dollar denominated multilateral agency debt instrument, or any bond issued under the Loans Ordinance, or any debentures, loan stocks, funds, bonds or notes denominated otherwise than in the currency of Hong Kong except to the extent that the same shall be redeemable, or may at the option of any person be redeemed, in the currency of Hong Kong.

'Hong Kong stock' means the stock the transfer of which is required to be registered in Hong Kong (s.2(1)).

4.1 Contract note, not being jobbing business (Head 2(1))

'Sale or purchase' of Hong Kong stock includes any disposal or acquisition (other than by allotment) for valuable consideration, any exchange, and any transaction in respect of which an instrument is deemed to be a transfer by way of sale (s.19(16)).

Under s.19(1), any person who effects any sale or purchase of Hong Kong stock as principal or agent shall:

(a) make and execute a contract note;

(b) cause the note to be stamped under Head 2(1) or (2); or in the case of a note to which s.45 relief applies, under s.13(2) after adjudication:

   (i) in the case of a sale or purchase effected in Hong Kong, not later than two days thereafter; or

   (ii) in any other case, not later than thirty days thereafter;

(c) if he is the agent, transmit the stamped note to his principal;

(d) cause an endorsement to be made on the instrument of transfer of the stock, or cause a stamp certificate to be issued in respect of the instrument, to the effect that:

   (i) stamp duty has been paid on the contract note under Head 2(1) or (2); or

   (ii) in the case of a contract note where the shares were transferred between associated bodies corporate to which s.45 relief applies, the contract note has been stamped after adjudication under s.13(2).

Contract notes for a sale or purchase of Hong Kong stock is stamped under Head 2(1) at the rate of $2 for every $1,000 (i.e. 0.2%: bought note at 0.1% and sold note at 0.1%) of the higher of the consideration or its value at the date on which the contract notes fall to be executed.

Stamp duty is charged in respect of each of the sale and sub-sale agreements between the intermediate parties, despite that only one set of bought and sold notes were executed by the original vendor and the ultimate purchaser: *Far East Consortium Ltd & Another v AG 2*.

Example 19

S entered into a sale agreement to sell 10,000 shares in Ace Ltd to T when the market value of the shares was $100 each. T entered into a sub-sale agreement to sell the same shares to U when the market value of the shares was $110 each.

The sale and sub-sale agreements are dutiable under Head 2(1). Stamp duty payable on the sale agreement is $2,000 (10,000 × $100 × 0.2%). Stamp duty payable on the sub-sale agreement is $2,200 on the contract notes (10,000 × $110 × 0.2%) plus $5 on the instrument of transfer under Head 2(4) (see **section 4.4** on 'Transfer of any other kind').

Example 20

V signed an AFS to sell an office to W. V paid $5 million cash and transferred 500,000 shares in a listed company to W. At the date of conveyance, the shares were quoted at $5 each.

The documents for the transfer of shares are the bought and sold notes and the instrument of transfer. The bought and sold notes are dutiable under Head 2(1) and the stamp duty on each note is 0.1% of $2.5 million (500,000 × $5), i.e. $2,500. The instrument of transfer is dutiable under Head 2(4) at a fixed duty of $5.

Consideration for the transfer of the property is $7.5 million ($5 million + $2.5 million). The documents for the transfer of the property are the AFS and the conveyance on sale. The AFS is dutiable under Head 1(1A), and the stamp duty payable is $300,000 ($8 million × 3.75%). Stamp duty payable on the conveyance on sale executed in conformity with the duly stamped AFS is $100.

4.1.1 Stock borrowing and lending transactions

A **'stock borrowing transaction'** is one in which Hong Kong stock is borrowed by a stock-broker for the sole purpose of settling a sale of Hong Kong stock, with an undertaking to return the stock within a specified period.

A **'stock return transaction'** is one in which Hong Kong stock of the same quantity and description as that borrowed is returned within the specified period.

Provided that the following conditions are satisfied, stock borrowing and lending transactions are not chargeable to stamp duty (s.19(11)):

(a) The borrowed stock must have been used for one or more specified purposes as defined under s.19(16) ;

(b) A stock return must have been made in respect of the borrowed stock;

(c) The borrower must have complied with any demand made by the lender for the return of stock of the quantity and description as that was previously borrowed;

(d) The borrower has to pay the lender equivalent amounts of the dividends paid on the borrowed stocks; and

(e) The lender's risk of loss or opportunity for gain from the borrowed stocks is not reduced by the lending.

SOIPN 2 (Revised) sets out a summary of the Collector's interpretation of the provisions for granting relief for stock borrowing and lending transactions, and provides details of the Stamp Office's practice in implementing them.

4.1.2 Deemed sale and purchase of stock

Section 19(1E) deems certain transactions in Hong Kong stock to be a sale and purchase of Hong Kong stock. SOIPN 4 sets out the current practice of the Collector in administering these provisions. Contract notes of the deemed sales and purchase of stock are required to be made and executed, and stamp duty is payable on these notes under Head 2(1) by reference to the value of the stock transferred.

In order that s.19(1E)(a) may apply, the transaction in question must effectuate a transfer of beneficial interest in Hong Kong stock by any means, whether by electronic means or by means of an entry in any recording or bookkeeping system or otherwise, and whether under or through a recognised clearing house or any other person or organisation such as stockbrokers, custodians, etc. providing a clearing or transfer service.

In applying the deeming provisions, to determine the persons liable for stamp duty and the amount chargeable, the person disposing of the stock is deemed to be the person effecting the sale. The person acquiring the stock is deemed to be the person effecting the purchase. The deemed seller and purchaser are the principals who are liable to make and execute the relevant contract notes

and to pay the applicable stamp duty, unless an agent exists. The person maintaining the record of the transactions is deemed to be the agent effecting the sale and purchase (except in the case of a recognised clearing house). Such an agent is the person liable to pay the requisite stamp duty and responsible for making and executing the relevant contract notes. The value of the stock in the transaction is deemed to be the amount or value of the consideration for the sale and purchase (s.19(1E)(b)).

The deeming section does not apply where the transaction would, if it were effectuated by a transfer chargeable with stamp duty under Head 2(3), be a transfer of the kind exempted under s.27(5). Section 27(5) exempts a transfer chargeable under Head 2(3) from stamp duty if the transfer is made:

(a) for a nominal consideration for the purpose of securing the repayment of a loan; or

(b) for effectuating the appointment of a new trustee; or

(c) under which no beneficial interest passes in the property conveyed or transferred; or

(d) to a beneficiary by a trustee or other person in a fiduciary duty under a trust (see **section 7** on 'Voluntary disposition *inter vivos*').

Section19(1E) would also not apply to a transaction which is exempted under any other provisions of the SDO such as s.45 exemption for transactions between associated bodies corporate (see **section 8.2** on 'Relief under s.45').

4.2 Contract note in respect of jobbing business (Head 2(2))

'**Jobbing business**' is defined in s.2(1) to mean any business carried on by an exchange participant which is specified as jobbing business by regulations made under s.63.

Contract notes in respect of jobbing business are stamped at $5 each.

4.3 Transfer operating as a voluntary disposition *inter vivos* (Head 2(3))

Under s.2(1)**, 'instrument of transfer'** means an instrument by means of which any Hong Kong stock is transferred, and includes a letter of renunciation.

Stamp duty on an instrument of transfer of Hong Kong stock operating as a voluntary disposition *inter vivos*, i.e. a gift during life time, is at $5 and $2 for every $1,000 (i.e. 0.2%) or part thereof of the value of the stock (see **section 7** on 'Voluntary disposition *inter vivos*'). The donor and done are jointly and severally liable for the stamp duty.

4.4 Transfer of any other kind (Head 2(4))

Other instruments of transfer will be charged at a fixed duty of $5. However, with effect from 2003/04, instruments of transfer relating to the issue of units under unit trust schemes by fund managers or redemption of units under unit trust schemes are exempt from the fixed duty of $5.

Example 21

The management of X Ltd is considering the following business proposals:

(a) To acquire all the shares in Y Ltd at $10 million, which is the fair market value of the shares;

(b) To establish a wholly-owned subsidiary in Hong Kong with a share capital of $1 million.

The documents for the proposed acquisition of the shares in Y Ltd are the bought and sold notes and the instrument of transfer. The bought and sold notes are dutiable under Head 2(1) and the stamp duty on each note is 0.1% of $10 million, i.e. $100,000. The instrument of transfer is dutiable under Head 2(4) at a fixed duty of $5.

The documents for the formation of the proposed subsidiary do not fall within any the charging heads and are not dutiable.

5 Hong Kong bearer instrument (Head 3)

Topic highlights

The stamping of Hong Kong bearer instruments is governed by Head 3 in the First Schedule.

'Bearer instrument' is defined in s.2(1) to mean any instrument to bearer by delivery of which any stock can be transferred, but does not include an instrument relating to stock which consists of a loan expressed in terms of currencies other than that of Hong Kong, except to the extent that the loan is repayable, or may at the option of any person be repaid, in the currency of Hong Kong.

'Hong Kong bearer instrument' is also defined in s.2(1) as a bearer instrument issued:

(a) in Hong Kong; or

(b) elsewhere by or on behalf of a body corporate formed, or an unincorporated body of persons established, in Hong Kong.

5.1 Hong Kong bearer instrument issued in respect of any stock (Head 3(1))

Hong Kong bearer instruments issued in respect of any stock are stamped before issue at $3 per $100 or part thereof (i.e. 3% of the market value at the time of issue). An exemption applies in respect of any unit in a unit trust scheme where the terms of the scheme restrict the trust funds to investing in loan capital.

5.2 Hong Kong bearer instrument given in substitution for a duly stamped instrument (Head 3(2))

Stamp duty on Hong Kong bearer instruments given in substitution for a like instrument duly stamped under Head 3(1) is at a fixed duty of $5.

6 Duplicates and counterparts (Head 4)

Topic highlights

The stamping of duplicates and counterparts is governed by Head 4 in the First Schedule.

Where the stamp duty on the original instrument is less than $5, the duplicate or counterpart will only attract the same amount of stamp duty as that on the original. In any other cases, stamp duty on the duplicate or counterpart of a dutiable instrument is at a fixed duty of $5.

7 Voluntary disposition *inter vivos*

Topic highlights

When an immovable property or stock is transferred at a consideration which is substantially below what would be considered an adequate amount, the transfer is deemed to be a conveyance or transfer operating as a voluntary disposition *inter vivos* and is chargeable with stamp duty under s.27(4) on the basis of the market value of the property or stock. However, a voluntary disposition without a change of beneficial ownership will not attract stamp duty.

Section 27 applies to an AFS and a conveyance on sale of immovable property, and transfer of Hong Kong stock. It does not apply to a lease, thus a lease at a rent below market rent cannot be charged on the basis of market rent. However, a lease can be treated as a conveyance on sale if the lease is granted for nil or inadequate consideration (see *Littlewoods Mill Order Stores v McGregor* [45 TC 519]). If so, stamp duty will be charged under Head 1(1) as if the lease were a voluntary disposition *inter vivos*.

For the purpose of s.27 **'conveyance'** includes any agreement for a lease or any release or renunciation of immovable property: s.27(6).

Stamp duty cannot be avoided by stating a lesser amount of consideration in the instrument as s.27 empowers the Collector to charge stamp duty on a conveyance of immovable property or transfer of Hong Kong stock as voluntary disposition *inter vivos* when:

(a) a conveyance or transfer not expressly worded as a gift has the effect of a gift, e.g. a conveyance or transfer without any consideration; and

(b) a conveyance or transfer is for an inadequate consideration.

The consideration will be deemed to be inadequate if the conveyance or transfer confers a substantial benefit on the person to whom the property is conveyed or transferred (s.27(4)).

Indeed, intentional understatement of consideration (contrast to selling at below market value) for the purpose of mitigating stamp duty payable is an offence under s.59.

When s.27(4) applies, the conveyance or transfer will be chargeable with stamp duty on the basis of the market value of the property or stock, rather than the amount specified in the relevant instrument. Even if the transaction is at arm's-length, in good faith and for valuable consideration, stamp duty will still be imposed on the market value (see *Lap Shun Textiles Industrial Co. Ltd v Collector of Stamp Revenue*[1 HKTC 880]). The criterion for voluntary disposition *inter vivos* is to see whether the conveyance or transfer confers a substantial benefit, which does not depend on the parties' intentions but upon an objective examination of the factual elements.

In *Chan Li Chai Medical Factory (Hong Kong) Ltd v Collector of Stamp Revenue* [(2001) HKRC 90-111], the assignments of two properties from the trustee of Chan Li Chai (a defunct Chinese family partnership) to a limited company (Chan Li Chai Medical Factory (Hong Kong) Ltd) which took over the business of the partnership were held to be conveyances operating as voluntary disposition *inter vivos* within the meaning of s.27(4), and were chargeable with stamp duty based on the market value of the properties.

In *Zung Fu Co Ltd v Collector of Stamp Revenue* [(1973) HKTC 853], it was held that the date of conveyance is the material date for valuation of the property for the purpose of s.27. However, as a concession, it is the practice of the Collector to take the date of AFS as the material date.

It should be noted that s.27(4) provides that if marriage is the consideration for a conveyance of immovable property or a transfer of Hong Kong stock, the conveyance or transfer is not deemed to be a conveyance or transfer operating as a voluntary disposition *inter vivos*. Thus, a conveyance or transfer is not chargeable with stamp duty if marriage is the consideration. However, the conveyance or transfer has to be adjudicated (see **section 9.5** on 'Adjudication').

Moreover, s.27 does not apply to a conveyance of immovable property or transfer of Hong Kong stock if no beneficial interest passes upon conveyance or transfer (s.27(5)). This applies to a conveyance or transfer:

(a) made for a nominal consideration to secure the repayment of an advance or loan;

(b) made to effect the appointment of a new trustee;

(c) under which no beneficial interest in the property passes, e.g. a distribution *in specie* on liquidation of a company;

(d) made to a beneficiary by a trustee or other person in a fiduciary capacity under any trust.

Example 22

Andrew, Brian and Connie were the co-owners of a residential property in Causeway Bay. On 1 July 2013, Connie assigned her one-third share in the property, for no monetary consideration, to Andrew and Brian. The market value of the property at that date was $4,800,000.

Because of the inadequacy of consideration, the transfer of Connie's share in the property would be regarded as a voluntary disposition *inter vivos* for stamp duty purposes: s.27(4). Under s.27(1) , stamp duty is chargeable on the market value of the property transferred. In this case, the market value of Connie's share was $1,600,000 (i.e. $4,800,000 × 1/3), and the duty payable is $100.

If Connie had not contributed any money for the purchase of the property and she was only included as one of the purchasers so as to enable Andrew and Brian to get a mortgage loan more easily, Connie would not have any beneficial interest in the property. In other words, no beneficial interest is transferred to Andrew and Brian upon the assignment. By virtue of s.27(5), s.27(1) would not apply to substitute the market value for the consideration of the conveyance. However, strong evidence has to be submitted to the Collector to establish the fact that Connie has no beneficial interest in the property.

HKICPA May 2004 (Amended)

Self-test question 1

In December 2012, A Ltd purchased a shop for investment at $20 million and paid stamp duty accordingly. Notwithstanding the lack of relationship between A Ltd and the seller, due to a serious cash flow problem of the seller, the sale price of the shop was found to be 20% less than the then market value.

Required:

Explain the stamp duty implication in respect of the undervalued purchase of the shop by A Ltd.

HKICPA June 2011 (Amended)
(The answer is at the end of the chapter)

8 Exemptions and reliefs

Topic highlights

The major exemptions and reliefs are provided under ss.39 to 46 and ss.47A and 47B as follows:

Section	Exemptions / Reliefs
39	Instruments generally exempted
40	Instruments specially exempted

41	Exemption for Government or public officer
42	Relief for leases between Government/public officer and another person
43	Relief for leases of consular premises
44	Relief for gifts to exempted institutions
45 / 29H(3	Relief for conveyance or transfer between associated bodies corporate
46	Exemption for instruments affecting immovable property made for new Government lease or exchange
47A	Exemption for transfer of units of constituent funds under MPF Schemes
47B	Exemption for instruments of transfer relating to indirect allotment or redemption of units under unit trust schemes

8.1 General exemptions

The following exemptions and reliefs are provided under ss.39 to 44 and s.46:

(a) Conveyance on sale to the Government;

(b) Leases and grants by the Government;

(c) Instruments executed by the Housing Authority, Urban Council and Regional Council for the purpose of the relevant Ordinances;

(d) Lease or agreement for lease made in respect of consular premises with exempted person;

(e) Instruments exempted under the Bankruptcy Ordinance and Companies Ordinance;

(f) Instruments executed by the Government or public officer for official purpose;

(g) Instruments affecting immovable property made for new Government lease or exchange;

(h) Transfer of units of constituent funds under MPF schemes;

(i) Instruments of transfer relating to indirect allotment or redemption of units under unit trust schemes.

(j) Gift of immovable property or Hong Kong stock to exempted charitable institutions;

The Government, any incorporated public officer or any person acting in the capacity of a public officer is exempt from payment of stamp duty. However, this does not mean that the instrument itself is exempt from stamp duty. The other party to the instrument, if any, and not being an exempted person, is still liable for payment of the full amount of duty chargeable.

For leases of consular premises or leases between the Government or incorporated public officer and another party, only 50% of the duty chargeable is payable by the other party.

An exempted charitable institution means a charitable institution or trust of a public character that are exempt from tax under s.88 of the IRO. The gift must be an absolute gift, and the donor must not receive or retain any benefit from the transfer. If it is not an absolute gift, the transfer will be treated as a voluntary disposition *inter vivos* and stamp duty will be chargeable on the market value.

8.2 Relief under s.45/s.29H(3)

Relief under s.45 for conveyance of immovable property (Head 1(1)) and 1(1AA)), or transfer of Hong Kong stock (Head 2(1) and 2(3)) between associated bodies corporate only applies when:

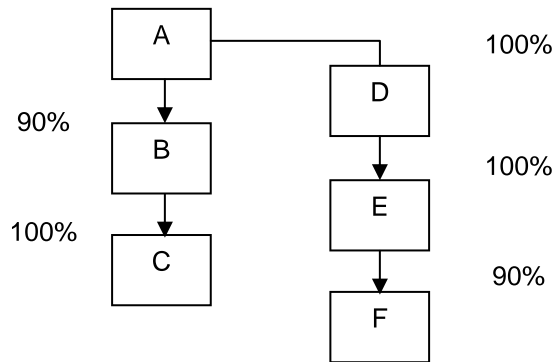
(a) one of the bodies corporate is the beneficial owner of not less than 90% of the issued share capital of the other; or

(b) a third body corporate is the beneficial owner of not less than 90% of the issued share capital of each of the bodies corporate.

Issued share capital refers to both ordinary and preference shares at par value; and s.45 relief is available where ownership can be traced through shareholdings in another body corporate.

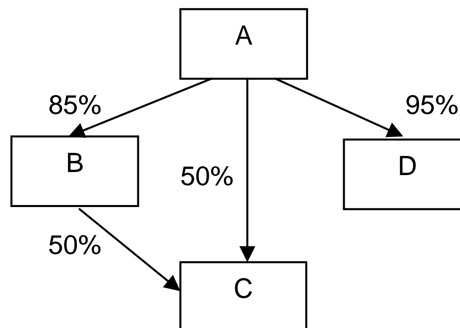
Example 23

A, B, C, D, E and F with the following group structure are associated bodies corporate eligible for the relief under s.45. A holds directly 90% of B and indirectly 90% of C. In addition, A effectively holds 90% or more of the shareholdings in D, E and F.



Example 24

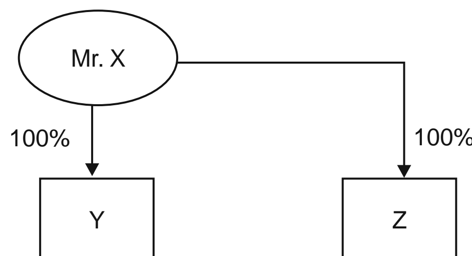
In the following group structure, A, C and D are associated bodies corporate eligible for the relief under s.45. A holds 95% of D and, directly and indirectly, 92.5% of C (50% + 85% × 50%). However, A and B, B and C as well as B and D are not associated.



It should be noted that companies held by an individual (not a corporate owner) will not qualify for the relief under s.45, which only applies to associated bodies corporate.

Example 25

Although Mr. X holds 100% of Y and Z, Y and Z are not associated bodies corporate eligible for the relief under s.45. This is because Mr. X is an individual, not a body corporate.



Place of incorporation

The location where the transferor, transferee or the holding company is incorporated is not relevant to claiming the s.45 relief. In other words, even if the transferor, transferee or the holding company was an overseas company, as long as it has met the conditions under s.45, it can claim the s.45 relief from stamp duty. However, application for the relief must be supported by a statutory declaration made by a responsible officer of the holding company, or its solicitor; and the instrument must be adjudicated (see **section 9.5** on 'Adjudication').

AFS for residential properties

Section 29H(3) provides the same relief for AFS (residential properties – Head 1(1A) and Head 1(1B)) if a conveyance on sale was executed in conformity with that AFS and the conveyance on sale would not be chargeable to stamp duty by virtue of s.45.

It should be noted that the s.45 relief is not available for leases of immovable property between associated bodies corporate which are chargeable under Head 1(2).

Subsequent condition

After the conveyance or transfer between associated companies, the transferor and transferee have to **remain associated for at least two years**. If they cease to be associated within the two-year period, the stamp duty exemption is revoked and duty is payable within thirty days of the change (s.45(4)(c) and (5A)).

If the transferor is liquidated within two years, s.45 relief may not be revoked in the following situations:

(a) The transferor is the holding company of the transferee and there is another holding company of the transferor which continues in existence during the two-year period; or

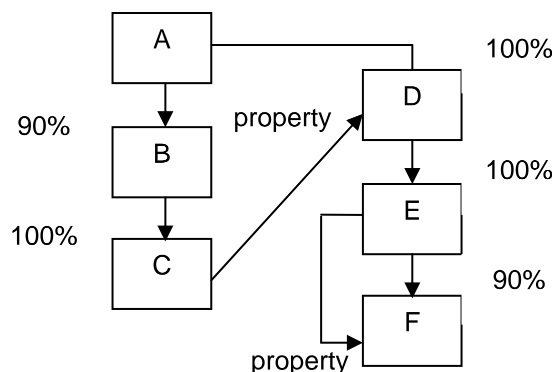
(b) The transferor and the transferee are under the common control of a holding company and that holding company retains not less than 90% of the shareholdings in the transferee during the two-year period.

Example 26

Section 45 relief will not be revoked in the following situations:

(a) E transfers a property to its subsidiary F. E may be liquidated within two years of the transfer (provided D remains as the holding company of F).

(b) C transfers a property to D. C may be liquidated within two years of the transfer (provided A remains as the holding company of D).



However, the following **anti-avoidance provisions** prevent the abuse of s.45 relief, and exemption shall not apply to instruments executed in connection with an arrangement under which:

(a) any part of the consideration for the transfer of immovable property or Hong Kong stock was provided or received, directly or indirectly, by a person other than an associated body corporate of the transferor or transferee (s.45(4)(a)).

(b) beneficial interest in the immovable property or Hong Kong stock was previously conveyed, transferred, sold or purchased, directly or indirectly, by a third person (s.45(4)(b)).

(c) the transferor and transferee were to cease to be associated due to a change in shareholding in the transferee within two years of the transfer (s.45(4)(c)).

If money has been obtained from a bank for the purpose of acquiring the property from an associated body corporate, s.45 relief might be denied pursuant to s.45(4)(a) as the bank is an unrelated non-associated person. However, the Collector has issued a ruling stating that as long as he is satisfied that the loan was made by a bank or a deposit-taking company in the ordinary course of business, and that neither the bank nor the deposit-taking company had any interest in the property other than as security, the provision of the purchase money by that bank or deposit-taking company would not cause a denial of the s.45 relief.

Example 27

In 1971, A Ltd acquired a plot of land in Yuen Long ('the Land') and erected thereon a factory for production. Due to the relocation of its manufacturing process to the Mainland, the factory in Yuen Long had been left vacant since 2011. In 2012, A Ltd resolved to put the Land in valuable use. It also planned to diversify its business mix by engaging in property investment in Hong Kong.

A Ltd established a wholly-owned subsidiary in Hong Kong, B Ltd, with a view to redeveloping the Land as a residential complex. A Ltd contracted to sell the Land to B Ltd at a consideration of $200 million plus 50% of the net profits realised by B Ltd from the redevelopment. The fair market value of the Land at that time was $500 million.

B Ltd borrowed $150 million from Bank C to finance the initial land cost of $200 million. The loan was secured by a fixed deposit of $100 million in the name of A Ltd, which was placed with a branch of Bank C in the United States.

Required:

Discuss B Ltd's exposure to stamp duty in relation to its purchase of the Land from A Ltd.

Solution

B Ltd was a wholly-owned subsidiary of A Ltd. In other words, A Ltd held 100% of the issued share capital of B Ltd. A Ltd and B Ltd were thus associated corporate bodies in terms of s.45(2). Therefore, by virtue of s.45(1), stamp duty under Head 1(1) should not be charged on the conveyance of the Land from A Ltd to B Ltd.

Strictly speaking, the fact that B Ltd had arranged a loan from Bank C for the purpose of acquiring the Land might trigger the application of s.45(4)(a) to deny the exemption under s.45(1). However, the Collector has issued a ruling (see the Law Society of Hong Kong Circular No. 1/83), stating that as long as he is satisfied that the loan was made by Bank C in the ordinary course of business, and that the bank did not have any interest in the Land other than as security, the provision of funds by the bank would not result in the exemption being lost.

After the conveyance, A Ltd and B Ltd had to remain associated for at least two years. Otherwise, the stamp duty exemption would be revoked and duty would be payable under s.45(5A).

HKICPA May 2010 (Amended)

Self-test question 2

XYZ is a company incorporated in Country A. It does not carry on business in Hong Kong nor have any business presence in Hong Kong. It has a 90% owned subsidiary, HKCO in Hong Kong.

HKCO carries on a manufacturing business in Hong Kong. It has a 100% owned subsidiary, DGCO in Dongguan, Mainland China. DGCO was set up in 1996 to carry out part of the manufacturing process for HKCO in the Mainland.

XYZ plans to transfer the shares in HKCO to its wholly owned subsidiary, OSCO, a company incorporated in Country B under a group restructuring exercise.

Required:

(a) Advise on the Hong Kong tax implications of the proposed transfer of the shares in HKCO to OSCO.

(b) If the shares in DGCO were transferred to OSCO (instead of the shares in HKCO), what would be the Hong Kong tax implications?

HKICPA February 2007 (Amended)

(The answer is at the end of the chapter)

8.3 Other exemptions under ss.47A and 47B

With effect from 1 December 2000, four specific types of unit transfers under MPF schemes are exempt from the requirements to pay the fixed stamp duty of $5 per instrument of transfer and to submit the instrument of transfer to the Collector for endorsement to the effect that it is not chargeable with *ad valorem* stamp duty.

The exempted transactions are:

(a) indirect allotment of units by Constituent Funds under MPF schemes to scheme members through the fund managers;

(b) redemption of units in Constituent Funds by MPF scheme members;

(c) indirect allotment of units by Approved Pooled Investment Funds to Constituent Funds under MPF schemes through the fund managers; and

(d) redemption of units in Approved Pooled Investment Funds by Constituent Funds under MPF schemes.

Previously, stamp duty was waived for the trading of exchange traded funds ('ETFs') with no Hong Kong stock in their portfolios. The stamp duty concession in respect of the trading of ETFs to cover ETFs with the value of Hong Kong stock not exceeding 40% of the aggregate value of the underlying portfolio was implemented by the Stamp Office from 25 February 2010 onwards. ETFs satisfying the requirement can apply to the Stamp Office for the concession under s.52.

8.4 Remission of stamp duty by Chief Executive

The Collector is conferred with the power to remit the whole or any part of the penalty imposed under s.9 for late stamping, but he has no power to remit the stamp duty. Section 52 provides that the Chief Executive may remit, wholly or in part, the stamp duty payable; or refund, wholly or in part, the stamp duty paid.

9 Stamp duty administration

Topic highlights

The major stamp duty administration issues relate to the methods of stamping, time limit and person liable for stamping, penalty for late stamping and failure to disclose relevant information, adjudication, appeal against assessment and effect of non-stamping.

9.1 Methods of stamping

The stamping of instruments generally takes place by denoting on the face of the instrument the payment of stamp duty when the instrument is presented to the Stamp Office for stamping (s.18B). With the growth of e-commerce, the Government has also introduced an alternative way of stamping certain instruments in the form of an electronic record (ss.18C to 18J).

The Collector may, upon application made through submission of a paper form or electronically, issue a stamp certificate in paper form or as an electronic record via the internet; and the payment of the stamp duty can be made on-line or through existing payment channels. The electronic stamping system is available only in respect of property transactions stamped within the normal time limits, although late stamping and payment of penalties in respect of instruments which are not more than 4 years late and which do not involve a request for remission of penalty can also be undertaken through the electronic stamping system.

However, the following cannot be dealt with under the electronic stamping system:

(a) adjudication cases;

(b) cases involving an application for exemption or relief or through the exercise of the Chief Executive's discretion pursuant to s.52; and

(c) stock transactions.

Moreover, a stamp duty assessment will be issued by the Collector:

(a) where the value of the immovable property or stock being transferred cannot be ascertained at the time of presentation of the instrument for stamping; and

(b) when the market value of property or stock transferred exceeds the stated consideration.

9.2 Time limit and person liable for stamping

All dutiable instruments must be stamped either before execution or within a certain period of time after execution, as follows:

Instrument	Time limit for stamping	Person liable
Conveyance on sale and AFS of immovable property in Hong Kong	30 days after execution	All parties (usually payable by the purchaser)
Conveyance on sale and AFS of immovable property in Hong Kong chargeable with SSD	30 days after execution	All parties (usually payable by the purchaser)
Lease and agreement for lease of immovable property in Hong Kong	30 days after execution	All parties
Contract notes (bought and sold notes) of Hong Kong stock	2 days after the sale or purchase if effected in Hong Kong; or 30 days after the sale or purchase if effected outside Hon Kong	Agent or principal

Instrument	Time limit for stamping	Person liable
Transfer as voluntary disposition of Hong Kong stock	7 days after execution if executed in Hong Kong; or 30 days after execution if executed outside Hong Kong	Transferor and transferee
Instrument of transfer of Hong Kong stock	Before execution; or 30 days after execution if executed outside Hong Kong,	Transferor and transferee
Hong Kong bearer instrument	Before issue	Issuer or agent
Duplicates and counterparts of chargeable instruments	7 days after execution or such longer period as the time for stamping the original instrument would allow	Per original document

Stamp duty cannot be avoided by executing the dutiable instruments outside Hong Kong and then bringing them into Hong Kong. If there are particular difficulties in stamping the documents executed outside Hong Kong within the specified time limits, the persons liable for stamp duty may apply for remission of the penalty for late stamping from the Collector.

9.3 Penalty for late stamping

Pursuant to s.9, any dutiable instrument not stamped within the specified time limit may be subject to a penalty for late stamping as follows:

Period late for stamping	Penalty
≤ 1 month	2 times the duty
> 1 month but ≤ 2 months	4 times the duty
> 2 months	10 times the duty

The Collector may remit the whole or any part of the penalty.

If a disclosure is made voluntarily and the delay is not deliberate, the Collector normally adopts the following formula in calculating the reduced penalty, subject to a maximum of $500:

Penalty = 14% x stamp duty payable x no. of days of delay / 365 days

Subject to a time limit of six years, the Collector may take legal proceedings against any person or persons liable for the payment of duty for recovery of the unpaid duty and any penalty for late stamping.

9.4 Penalty for failure to disclose relevant information

Section 11(1) requires that all facts and circumstances which affect the liability of an instrument to stamp duty, or the amount of stamp duty chargeable on the instrument, are to be disclosed in that instrument. Any person who with intent to defraud the Government executes an instrument in which all relevant facts and circumstances are not set out, or who is employed or involved in the preparation of such an instrument neglects to set out all relevant facts and circumstances, commits an offence (s.11(2)) and is liable to a fine at level 6 (i.e. $100,000) and one year imprisonment (s.60)). The Collector is also empowered to refuse to stamp the instrument or to stamp it subject to such conditions as he thinks fit (s.11(4)).

Before the commencement of criminal proceedings in relation to the offence, the Collector has the power to compound any such offence (s.11(3)). However, no criminal proceedings can be instituted by the Collector after the expiration of two years from the discovery of the offence or six years from the commencement of the offence, whichever is the earlier (s.61)).

9.5 Adjudication

Under s.13(1), a person may, upon the payment of an adjudication fee, request the Collector to adjudicate an instrument. Adjudication is a procedure under which the Collector adjudicates (i.e. determines) whether an instrument is chargeable to stamp duty and, if so, the amount of stamp duty payable.

After adjudication, if the Collector is of the opinion that the instrument is not chargeable with stamp duty, the instrument will be stamped with a stamp denoting that it is not chargeable with stamp duty. Otherwise, the Collector will assess the instrument for stamp duty. He will issue a notice of assessment of stamp duty to the person who requires the Collector to express an opinion or who is liable for stamping such instrument. If no appeal is made against the assessment, the assessment shall, after the expiration of a period of one month, be final and conclusive.

If the Collector finds that the amount of stamp duty so assessed is excessive within one month from the assessment, he may cancel the assessment and make another assessment in substitution as he may deem proper.

Although a Declaration of Trust is not chargeable with stamp duty, it is a common practice in Hong Kong to have a Declaration of Trust adjudicated at the time of its execution so as to obviate the problem of proving the authentication of the document at the time of executing a transfer deed from the trustee to the beneficiary.

9.5.1 Importance of adjudication

Adjudication is important for the following reasons:

(a) An adjudicated instrument will satisfy any third party as to the correctness of stamping.

(b) Certain instruments will not be regarded as properly stamped unless adjudicated (e.g. deeds of gift).

(c) Adjudication is part of the process of appeal in any dispute as to liability to stamp duty.

(d) There is doubt as to the chargeability or amount of stamp duty payable.

9.5.2 Compulsory adjudication

Adjudication is compulsory in the following cases:

(a) An AFS, a conveyance or transfer operating as a voluntary disposition *inter vivos* under s.27;

(b) An instrument conveying or transferring property in contemplation of sale which is treated as a conveyance or transfer operating as a voluntary disposition *inter vivos* under s.27;

(c) An instrument claimed to be exempt from duty under the provisions of s.45 relating to certain transfers between associated bodies corporate;

(d) An instrument (or duplicate or counterpart) claimed to be specially exempt from stamp duty or where it is claimed that no person is liable for the payment of the stamp duty;

(e) A conveyance or contract note to which s.24(2) applies (i.e. a transaction in consideration of a debt where the consideration would otherwise exceed the value of the property);

(f) An instrument to which s.44 applies (i.e. gifts to exempted institutions);

(g) A foreclosure order; and

(h) An appeal against a stamp duty assessment under s.14.

9.5.3 Adjudication fee

The adjudication fee is generally $50 as prescribed in the Fifth Schedule. However, no adjudication fee shall be payable in respect of the following instruments for which compulsory adjudication is required:

Section	Instrument
24(2)	Conveyance on sale/contract notes in consideration of a debt
27(3), 29F(2)	Instrument operating as a gift
29H(3), 45(3)	Instrument qualifying for the relief for the transfer of immovable property and stock between associated bodies corporate
44(3)	Instrument effecting a gift to exempted institution
Note 4 to Head 1(1) and Note 3 to Head 2(3)	Foreclosure order

9.6 Appeal against stamp duty assessment

Pursuant to s.14, any person who is dissatisfied with the assessment raised by the Collector after adjudication may:

(a) within a period of one month from the date on which the assessment is made or within such further period as the Court may allow if the Court, on application made by the person, is satisfied that the person was prevented by illness or absence from Hong Kong or other reasonable cause from bringing the appeal within the time limit;

(b) subject to any order of the Court, on payment of the stamp duty in conformity therewith or; where payment of the stamp duty or any part thereof is allowed to be postponed, on payment of the part (if any) of the stamp duty which is not allowed to be postponed; and

(c) by notice served on the Registrar of the District Court;

appeal against the assessment to the District Court and may, for that purpose, require the Collector to state and sign a case. The District Court will determine the correctness of the assessment. If the person is not satisfied with the determination of the District Court, further appeals may be made to the Court of Appeal (application for leave to appeal needs to be made within fourteen days of the judgment or order) and finally, to the Court of Final Appeal.

Stamp duty generally must be paid first. However, upon application in writing by the person liable for payment of stamp duty within fourteen days from the date on which the assessment is made and provision of satisfactory security, the Collector may postpone payment of stamp duty, wholly or in part (s.14(1A)). The Court may also allow an appeal to the Court without payment of the stamp duty or with part payment only, upon provision of satisfactory security, if it considers the payment of the duty would impose hardship on the person (s.14(1B)).

Possible grounds for stamp duty appeals include:

(a) whether a transaction is to be regarded as a voluntary disposition *inter vivos*;

(b) whether there is any change in beneficial ownership;

(c) whether the instrument is exempt from stamp duty;

(d) whether a conveyance on sale forms part of a larger transaction or a series of transactions;

(e) the valuation of immovable property; and

(f) the valuation of private company shares.

Pursuant to s.14(5A), the District Court may call upon opinions from members of the Lands Tribunal in respect of the valuation of immovable property.

Upon hearing, the Court will decide if the instrument is dutiable and if so, the quantum of stamp duty payable. If the amount assessed by the court is less than the amount assessed by the Collector, the excess will be refunded along with any excess penalty paid (s.14(4)). If the amount assessed by the Collector is not excessive, the Court will make an order confirming the assessment (s.14(5)).

9.7 Effect of non-stamping

9.7.1 Non-admissibility of instruments

In the case of a legal proceeding, s.15(1) stipulates that, subject to court orders or an endorsement of the Collector, no unstamped instruments can be accepted in evidence in any proceedings except in:

(a) criminal proceedings; or

(b) civil proceedings instituted by the Collector to recover stamp duty and/or penalty.

The court may order that an instrument not duly stamped be received in evidence in civil proceedings upon the personal undertaking of a solicitor to pay the stamp duty and penalty thereon (s.15(1A)).

The Collector will endorse an instrument not duly stamped if he has approved the postponement of payment of the stamp duty or that the court has made an order allowing an appeal against the stamp duty assessment without payment of the stamp duty or with part payment only.

9.7.2 Filing, registration, brokerage, commission and dividends

No instrument chargeable with stamp duty shall be acted upon, filed or registered by any public officer or body corporate unless such instrument is duly stamped; or endorsed by the Collector under s.14(1C) when the stamp duty is under appeal (s.15(2)). Therefore,

(a) the Land Registrar at the Land Registry cannot register an unstamped assignment of immovable property.

(b) the registrar of a company cannot register the change of shareholders upon the presentation of an unstamped instrument of transfer.

(c) the court cannot give judgment on the recovery of outstanding rent under an unstamped lease.

Any public officer who, or body associate which, fails to comply with s.15(2) incurs a penalty at level 2 (i.e. $5,000).

No broker or agent can legally claim any charge for brokerage or commission for the sale or purchase of Hong Kong stock if he failed to comply with s.19 to execute the contract notes (s.19(3)).

The unregistered shareholders are not entitled to any divided, bonus or rights issues in respect of the shares bought (s.21).

Self-test question 3

CBHK Group ('the Group') intends to commence a restructuring exercise and to transfer all its properties in Hong Kong to its property holding subsidiary, Investment Ltd. The Group will also purchase one property from an unrelated party by acquiring shares in a property holding company. The Group also noted that in 2007 they had purchased a building, from a subsidiary in which the Group had a 60% interest, on which no stamp duty was paid.

Required:

(a) State the scope of charge under the SDO in Hong Kong.

(b) Examine whether any relief is available in relation to the transactions involved.

(c) Assuming the value of the relevant property involved in the transactions is more than $20 million, identify the dutiable instruments and determine the rates applicable for the transfer of the property and shares.

(d) Explain the administration of stamp duty, in particular the time limit for stamping, the penalty for late stamping and the procedures for an appeal against an assessment; and advise the Group on the actions to be taken.

(e) Advise whether there will be Hong Kong profits tax implications for the profits derived from and expenses incurred in the restructuring exercise.

HKICPA September 2005 (Amended)
(The answer is at the end of the chapter)

10 Anti-avoidance measures

Topic highlights

There are specific anti-avoidance provisions in the SDO, such as those for group relief under s.45(5A) , but there are no general anti-avoidance provisions similar to ss.61 and 61A of the IRO.

10.1 Applicability of the *Ramsay* principle

In the absence of general anti-avoidance provisions in the SDO, if the Collector wishes to disregard a transaction for the avoidance of payment of stamp duty, he can rely on the *Ramsay* principle as enunciated by the House of Lords in *W T Ramsay Limited v IRC* [(1982) AC300].

The *Ramsay* principle enables the Court to disregard a pre-ordained series of transaction containing steps that are self-cancelling or without commercial substance. It applies when:

(a) there is a pre-ordained series of transactions or a single composite transaction; and

(b) there are steps inserted which have no commercial or business purpose apart from the avoidance of a liability to tax.

'Pre-ordained' means there was a practical likelihood that all the steps in the composite transaction must have been determined when the initial steps were carried out.

If the above conditions exist, the inserted steps are to be disregarded for fiscal purposes and the court must then look at the end result.

In *CSR v Arrowtown Assets Limited (2003),* the Court of Final Appeal applied the *Ramsay* principle to counter a transaction intended to avoid stamp duty, and held that *Ramsay* is a decision that the court is entitled, for fiscal purposes, to disregard intermediate steps as having no commercial purpose as a consequence of an orthodox exercise of purposive statutory construction. By applying *Ramsay*, the Court of Final Appeal ruled that the s.45 relief was not available to the transaction carried out in *Arrowtown Assets*.

10.2 Decided case: *Ramsay* principle and s.45 relief

Taxpayer	Subject matter	References
Arrowtown Assets Limited	Section 45 relief	(2003) 1 HKRC 90-129

CSR v Arrowtown Assets Limited [(2003) 1 HFRC 90-129]

The facts: Arrowtown Assets Limited ('Arrowtown'*),* a subsidiary of Shiu Wing Steel Limited ('Shiu Wing'), was chargeable with stamp duty in the amount of $349,658,565 on a Memorandum of Agreement dated 22 April 1997. Two property developers were interested in developing a piece of land owned by Shiu Wing. The ordinary shares ('A' shares with voting rights) of the parent company of Arrowtown were transferred to a company controlled by the property developer. The parent company of Arrowtown issued deferred shares ('B' shares with no voting rights) to its immediate holding company which was controlled by Shiu Wing. Arrowtown purchased the piece of land from Shiu Wing at a consideration of $12,714,856,874 in the form of a Loan Note and a deferred consideration at 12% of the surplus proceeds arising from the sale of residential units intended to be erected on the land. Arrowtown claimed that the group relief under s.45 was applicable notwithstanding there were two classes of shares ('A' shares and 'B' shares (which constituted more than 90% of the issued share capital in terms of dollar amount)), and no stamp duty was payable on the Memorandum of Agreement for the sale and purchase of the Land.

Decision: The District Court decided that Arrowtown failed to comply with the requirements for the group relief under s.45 as part of the consideration would be provided by non-group members and dismissed its appeal to the Stamp Duty assessment. Arrowtown appealed to the COA. The COA, by a majority, decided in favour of Arrowtown that it was entitled to the s.45 relief. The COA was of the view that the share transfer and the land transfer were separate transactions and the consideration for the land transfer was not provided by an outsider. The case finally reached the CFA. The judges of the CFA unanimously decided in favour of the Collector. By taking a purposive interpretation of s.45, they considered the *Ramsay* (or fiscal nullity) doctrine was applicable, and the 'B' shares (deferred shares) with no voting rights should be disregarded in determining the associated relationship of the parties.

Arrowtown is of significant importance as it demonstrates that both the Court and the IRD will continue to apply the *Ramsay* principle in Hong Kong to disregard pre-ordained series of transactions, or one single composite transaction, into which steps have been inserted which have no commercial purpose other than to avoid tax.

11 Stamp duty planning

Topic highlights

There are no general anti-avoidance provisions under the SDO. The principle of fiscal nullity may apply in aggressive avoidance cases, as in *CSR v Arrowtown Assets Limited* [(2003) HKRC 90–129]. To defend possible challenges from the Stamp Office, schemes or arrangements without commercial substance should be avoided in stamp duty planning.

The following are common methods used to reduce the exposure to stamp duty:

(a) No document, not duty;

(b) Holding immovable property in the name of a corporation;

(c) Purchasing immovable property by an exchange of property;

(d) Transferring shares in a non-Hong Kong holding company;

(e) Undertaking share allotment; and

(f) Utilising s.45 relief.

11.1 No document, no duty

Stamp duty is levied on documents, not on transactions. If a transaction can be effected verbally or by conduct, such as in the case of a lease of immovable property not exceeding three years, no stamp duty is chargeable.

11.2 Holding immovable property in the name of a corporation

There is a significant difference in the rates of stamp duty on contract notes on transfer of Hong Kong stock (0.2%) and conveyances of immovable property (maximum 4.25%). By disposing of the shares in a property holding company instead of selling the immovable property held by that company, liability to stamp duty can be reduced.

Example 28

P acquired a property at $8 million in the name of Q Ltd. He then sold the shares in Q Ltd at $9 million.

Stamp duty payable		$
On acquisition of property	$8m × 3.75%	300,000
On sale of shares in Q Ltd *	$9m × 0.2%	18,000
Total		318,000

* $9,000 on the sold note and $9,000 on the bought note for the sale and purchase of the shares.

If P acquired the property in his own name and sold the property, stamp duty would be charged as follows:

Stamp duty payable		$
On acquisition of property	$8m × 3.75%	300,000
On sale of property	$9m × 3.75%	337,500
Total		637,500

Furthermore, stamp duty on sale and purchase of the shares in the property holding company can be avoided if the company is incorporated in a jurisdiction with no stamp duty on share transfer and has a share register outside Hong Kong, such that the shares are not Hong Kong stock (see also **Example 30** below).

In general, the stamp duty on conveyance of immovable property (maximum 4.25%) is borne by the purchaser while the stamp duty on transfer of shares is equally shared by the transferor (0.1% on sold note) and transferee (0.1% on bought note). The actual payment of stamp duty may be subject to negotiation between the contracting parties.

One of the disadvantages of acquiring the shares in a property holding company is that there may be undisclosed hidden liabilities of the company such as undercharged tax, penalty, guarantees etc. Other disadvantages include lower valuation, higher interest rates and handling charges from banks for mortgage loans, and the cost of setting up and maintaining a company.

However, the biggest problem exists when a property is held as trading stock in the books of the company at its original cost and the purchaser of the company buys the shares at a premium, reflecting the market price of the property. Although the seller will be making a tax free gain on disposal of the shares in the company, when it is time for the buyer to sell the property, the subsequent buyer of the property may not wish to buy the shares in the company. The buyer of the company will then have to sell the property; and to foot the tax bill of the company based on the difference between the original book cost and the final sales price of the property. In effect, he will be paying the tax of the original purchaser of the property.

11.3 Purchasing immovable property by an exchange of property

If the purchase of immovable residential/non-residential properties can be effected by an exchange of properties between the seller and the purchaser, stamp duty is chargeable on any consideration paid or given for equality or the difference between the values of the exchanged properties, whichever is the higher. As stamp duty is not paid on the total value of the two properties conveyed, liability to stamp duty can be reduced.

Example 29

R and S have agreed to exchange their residential properties. R's flat is valued at $6 million and S's flat is valued at $7 million. R will pay S $1 million as equality money.

If the exchange is effected by an exchange of property under s.29C(10) , the deed of exchange will only be stamped by reference to the equality money. Stamp duty payable on the equality money of $1 million is $100.

The adequacy of the equality money will be assessed by virtue of s.29F. If no equality money was paid or if the equality money paid was inadequate, the difference between the market value of the properties exchanged will be used to determine the amount of stamp duty payable.

If, instead of effecting a deed of exchange, two separate conveyances were prepared, stamp duty would be paid on the value of the two properties conveyed. Total stamp duty payable would be $442,500 ($6m × 3% + $7m × 3.75%).

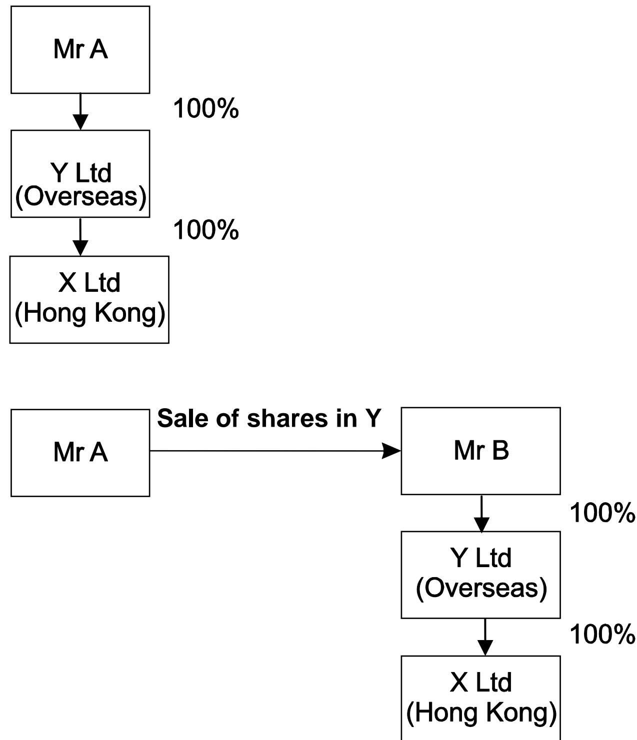
If a residential property is exchanged for a non-residential property or vice versa, the Collector accepts that the deed of exchange is stampable as if it were a chargeable AFS of that property. In other words, s.29C(10) will also apply to this situation (SOIPN 1, para 48).

11.4 Transferring shares in a non-Hong Kong holding company

One usual method to reduce the exposure to stamp duty is to use a non-Hong Kong company to hold shares in a Hong Kong company. Shares in the Hong Kong company will be transferred through the change in shareholdings of the immediate holding company, which is incorporated in a jurisdiction with no stamp duty on share transfer and has a share register outside Hong Kong.

Example 30

Y Ltd, a company incorporated outside Hong Kong, holds 100% of the shares in X Ltd, a Hong Kong company. The shares in Y Ltd, which are all owned by Mr. A, can be transferred free of Hong Kong stamp duty, from Mr. A to Mr. B, if Y's share register is kept outside Hong Kong such that the shares are not Hong Kong stock.



One of the disadvantages of keeping an offshore immediate holding company is the cost of setting up and maintaining such a company. Another disadvantage is that many offshore jurisdictions may be considered as tax haven countries and the potential buyer may not be comfortable with or interested in holding shares in companies incorporated in these offshore jurisdictions.

As in Example 28, If X Ltd holds a property as its trading stock, the purchaser of the shares in X Ltd will have to bear the tax on the profits on disposal of the property from X Ltd to a buyer who does not wish to buy the shares in X Ltd and be responsible for all the hidden tax liabilities of previous owners of X Ltd.

11.5 Undertaking share allotment

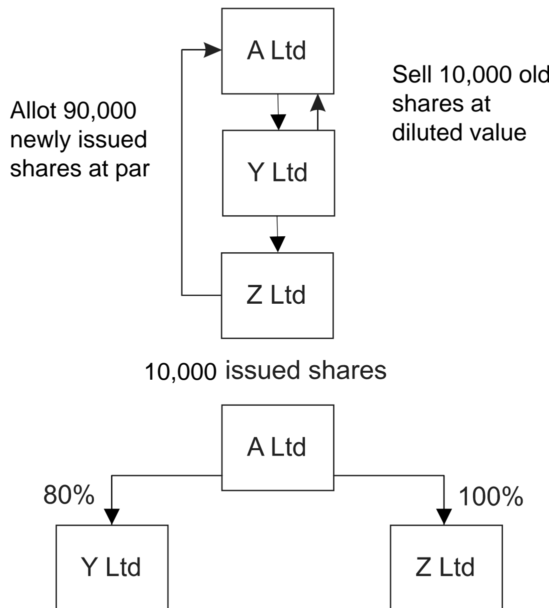
There is no stamp duty on newly issued shares and share allotment can be used to reduce the exposure to stamp duty.

Example 31

A Ltd holds 80% of the shares in Y Ltd which owns 100% of the shares in Z Ltd. Z Ltd has an issued share capital of 10,000 shares (par value at $1, net asset value at $1,000 per share). A Ltd wants to hold Z Ltd directly.

If Y Ltd sells all of its shares in Z Ltd to A Ltd, the transfer is chargeable with stamp duty as the s.45 relief does not apply (A Ltd and Y Ltd are not associated). Stamp duty payable would be $20,000 (10,000 × $1,000 × 0.2%).

However, stamp duty can be reduced if A Ltd is allotted 90,000 shares at par in Z Ltd (which is not chargeable with stamp duty), and Y Ltd then sells its 10,000 shares in Z Ltd at the diluted value of $100.90 each [(10,000 × $1,000 + $90,000) ÷ (10,000 + 90,000)] to A Ltd. The stamp duty payable would be reduced to $2,018 (10,000 × $100.90 × 0.2%).



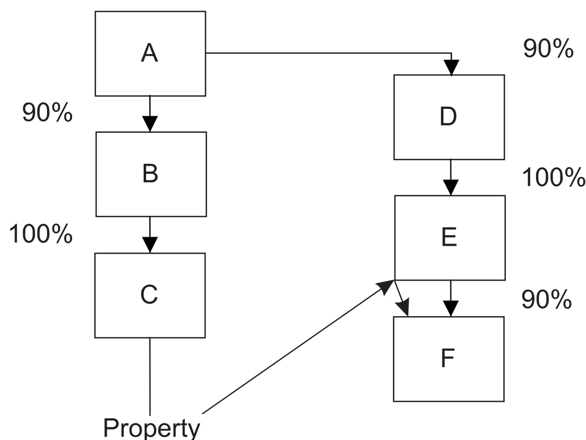
If Z Ltd needs to increase its authorised share capital for the issue of additional shares, there will be a charge of capital duty (0.1%, maximum $30,000) on the increased authorised share capital payable to the Companies Registry.

11.6 Utilising s.45 relief

Section 45 relief is available for the sale or transfer of immovable property or Hong Kong stock between associated bodies corporate. It is possible to make arrangements so as to utilise the relief.

Example 32

The group structure of A, B, C, D, E and F is as follows:



C owns an immovable property in Hong Kong and wishes to transfer it to F. Stamp duty is chargeable on the conveyance as C and F are not associated (A effectively holds 90% of C, but only 81% of F).

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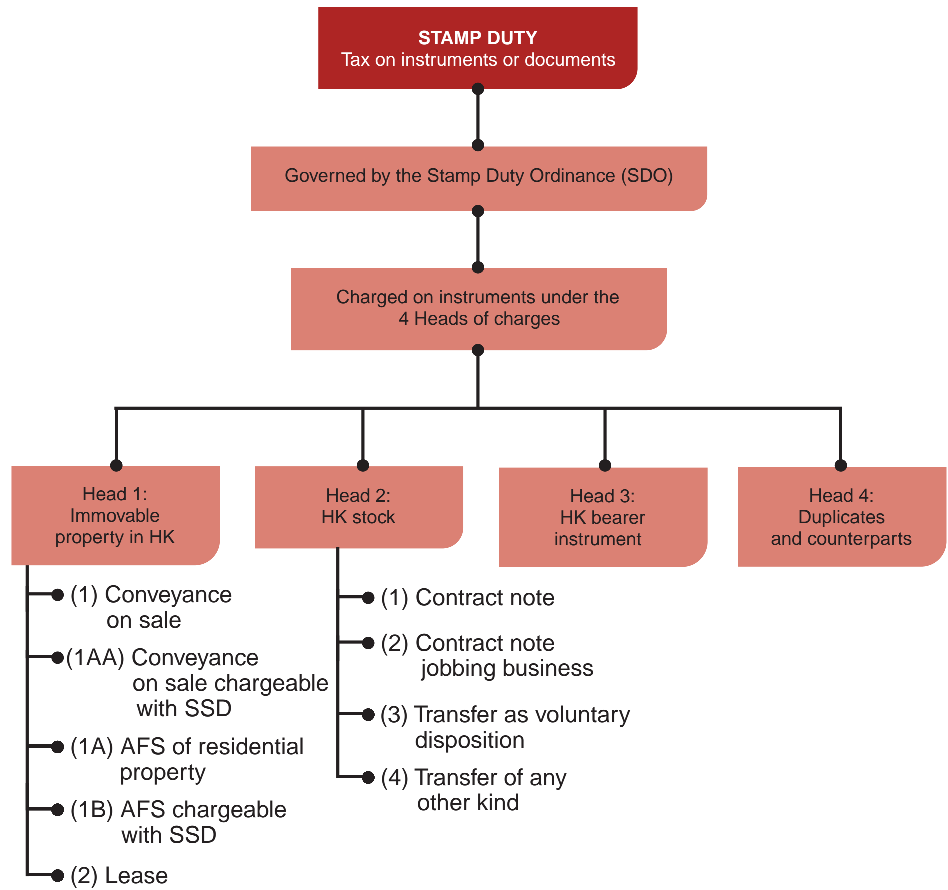
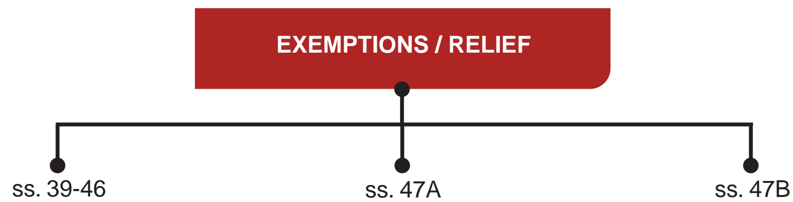
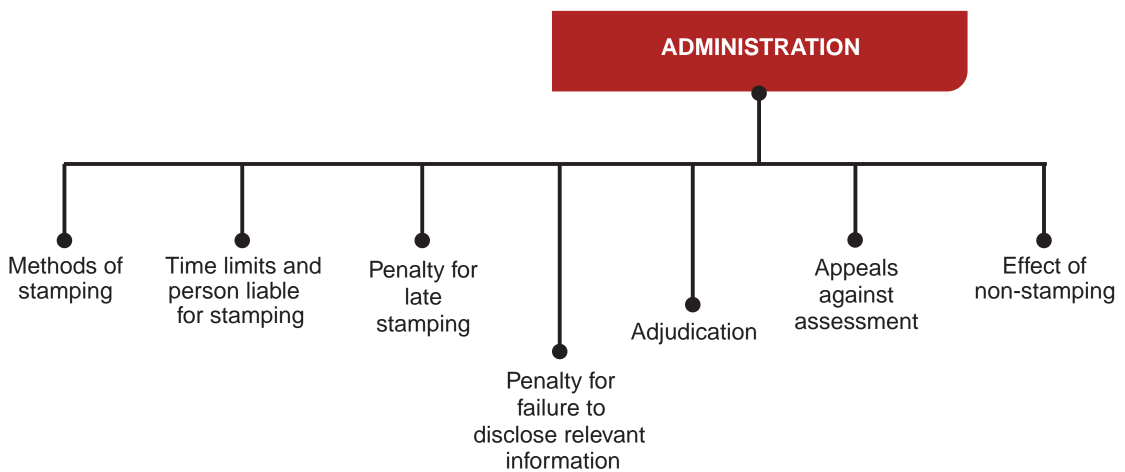
If C transfers the property to E first, E then transfers the property to F, stamp duty is avoided as C and E are associated (A owns 90% of the shares in C and E); and E and F are also associated (E owns 90% of the shares in F).

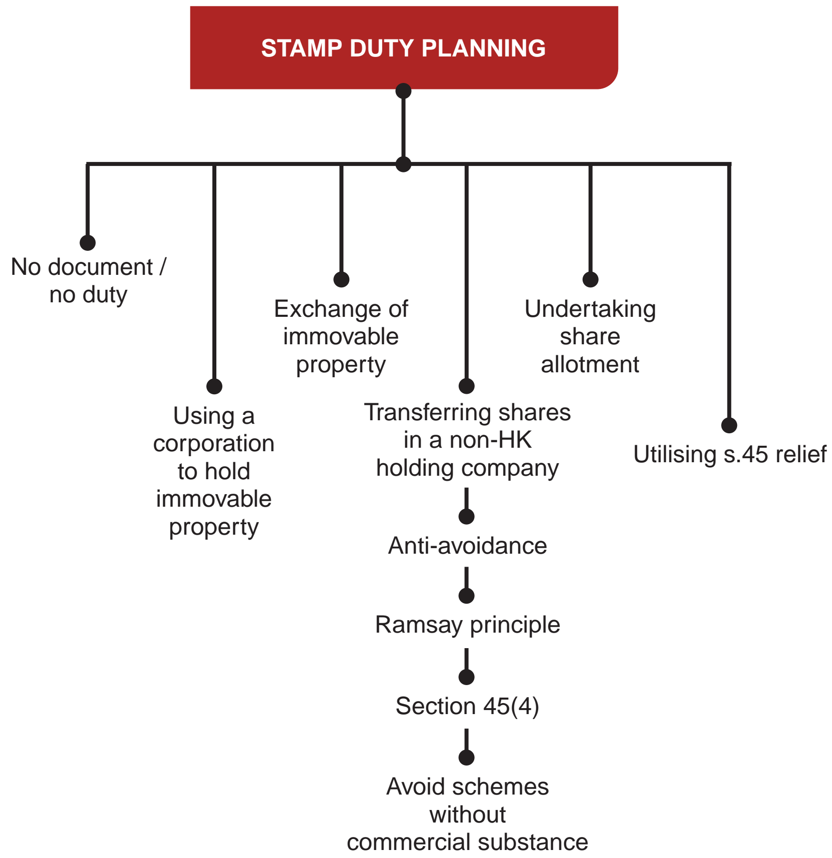
To avoid challenges from the Stamp Office, the presence of a commercial reason other than stamp duty savings for making the transfers within the group is important. A time gap of more than two years between the transfer to E and then to F would help.

Topic recap








STAMP DUTY PLANNING
No document / no duty
Using a corporation to hold immovable property
Exchange of immovable property
Transferring shares in a non-HK holding company
Anti-avoidance
Ramsay principle
Section 45(4)
Avoid schemes without commercial substance
Undertaking share allotment
Utilising s.45 relief

Answer to self-test question

Answer 1

Section 27(1) provides that any conveyance of immovable property as a voluntary disposition *inter vivos* shall be chargeable with stamp duty with the substitution of the market value of the property. Under s.27(4) , any conveyance of immovable property shall be deemed to be a voluntary disposition *inter vivos* if the Collector is of the opinion that by reason of the inadequacy of the consideration or other circumstances the conveyance confers a substantial benefit on the person to whom the property the property is conveyed or transferred.

Here, A Ltd purchased the shop at 20% less than the market value and such a discount did confer a substantial benefit to the company. The fact that the transaction between A Ltd and the seller was at arm's length would not prevent the imposition of stamp duty on the market value of the shop. In *Lap Shun Textiles Industrial Co Ltd v Collector of Stamp Revenue* (1 HKTC 880), the COA held that the application of ss.27(1) and (4) depended on whether the conveyance conferred a substantial benefit upon an objective examination of the factual elements, not the intentions of the parties concerned.

Therefore, by virtue of ss.27(1) and (4), the stamp duty on the relevant conveyance should be calculated based on the market value, rather than the sale consideration, of the shop.

The stamp duty payable should be calculated as follows:

Market value of the property = $20 million / (1 – 20%) = $25 million

Stamp duty payable = $25 million × 4.25% = $1,062,500

Answer 2

(a) *Profits tax*

As XYZ does not carry on any business in Hong Kong, any profit on disposal of the shares in HKCO falls outside the scope of s.14.

Stamp duty

Stamp duty is chargeable on the contract notes effecting the transfer of shares in HKCO to OSCO: Head 2(1). The rate is 0.2% on the amount of the consideration or the value of the stock being transferred, whichever is the higher. This is payable half by XYZ and half by OSCO on the contract notes effected.

The stamp duty for the instrument of transfer is $5.

Exemption from stamp duty is available for intra-group transfer of shares under s.45.

XYZ and OSCO are associated for the purpose of s.45, as XYZ is the beneficial owner of 90% of the issued share capital of OSCO. As such, they should be entitled to the exemption; and they should obtain adjudication for the s.45 relief.

To qualify for the exemption, XYZ and OSCO have to remain associated for at least two years after the transfer. If they cease to be associated within the two-year period, the stamp duty exemption will be revoked and duty is payable within 30 days of the change.

(b) On the facts available, it is likely that the shares in DGCO were held by HKCO for long-term investment:

(i) DGCO was the manufacturing arm of HKCO in the Mainland; and

(ii) The shares in DGCO were held by HKCO for more than 10 years.

Any profit/loss arising from the disposal of the shares would be of a capital nature and not taxable/deductible under profits tax.

The shares in DGCO are not Hong Kong stock for the purposes of the SDO. In this regard, no stamp duty is payable in Hong Kong on the documents effecting the transfer and application from exemption from stamp duty is not required.

Answer 3

(a) In Hong Kong, stamp duty is levied on the instruments of transfer of immovable property in Hong Kong and Hong Kong stock.

(b) Exemptions from stamp duty are available for intragroup transfers of immovable property or shares from one associated body corporate to another under s.45. The Group should obtain adjudication for the s.45 relief.

However s.45 relief is not available for the building previously acquired from its 60% subsidiary and the intended transfer of the Group's properties to its other subsidiary should not be entitled to the s.45 relief unless they are 'associated', i.e. when one company is the beneficial owner of at least 90% of the issued share capital of the other, or when a third company is the beneficial owner of at least 90% of the issued share capital of each.

(c) The dutiable instruments are the AFS (in case the property is residential property) and conveyance on sale. The applicable rate is 4.25% on the higher of the consideration and market value of the property.

Stamp duty is levied on the higher of the consideration paid and the value of the shares transferred and the rate is 0.2% ($2 per $1,000) per transaction; 0.1% on the bought note and 0.1% on the sold note. The instrument of transfer is chargeable at a fixed rate of $5.

(d) The time limit for stamping the AFS and conveyance on sale of immovable property in Hong Kong is 30 days after execution. The time limit for stamping the contract notes is two days after the sale or purchase (or 30 days if effected outside Hong Kong). The time limit for stamping the instrument of transfer is before execution (or 30 days after execution if executed outsider Hong Kong).

When an instrument which is chargeable with stamp duty is not stamped within the time specified, it can thereafter be stamped only upon payment of the duty owing and a penalty.

For delays in stamping not exceeding one month, the penalty is 2 times the amount of duty payable. For delays between one and two months, the penalty is 4 times the amount of duty payable. For delays of over two months, the penalty is 10 times the amount of duty payable.

The Collector has the discretionary power to remit the whole or any part of the penalty.

Actions for the Group to take:

(i) examine if s.45 relief is applicable;

(ii) if not, arrange an early meeting with the Collector, and identify reasons for late payment and request mitigation or remission of the penalty; and

(iii) arrange early payment of stamp duty.

To appeal against an assessment, any person who is dissatisfied with the assessment raised by the Collect after adjudication may:

(i) within a period of one month from the date on which the assessment is made or within such further period as the Court may allow if the Court, on application made by the person, is satisfied that the person was prevented by illness or absence from Hong Kong or other reasonable cause from bringing the appeal within the time limit;

(ii) subject to any order of the Court, on payment of the stamp duty in conformity therewith, or where payment of the stamp duty or any part thereof is allowed to be

postponed, on payment of the part (if any) of the stamp duty which is not allowed to be postponed; and

(iii) by notice served on the Registrar of the District Court; appeal against the assessment.

(e) Profits derived from the transfer of properties from the Group to Investment Ltd during the restructuring exercise may be subject to tax unless the relevant entity could establish to the satisfaction of the assessor that the gains thereon are capital in nature.

The IRD would examine the following:

(i) documents of intention;

(ii) length of holding;

(iii) financing;

(iv) classification in the accounts; and

(v) circumstances, etc.

The Group should collect relevant documents to substantiate their capital claims.

Expenses incurred in the restructuring exercise should be capital in nature and non-deductible.

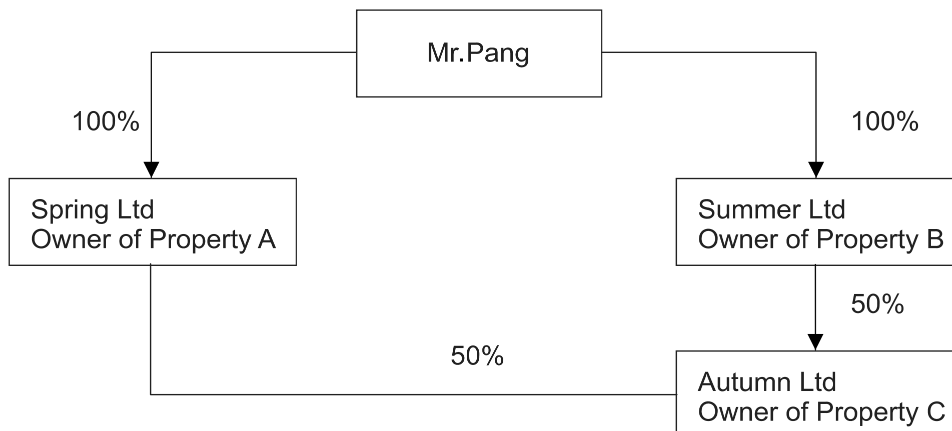
Exam practice

Mr. Pang

36 minutes

Mr. Pang is the beneficial owner of Spring Ltd, Summer Ltd and Autumn Ltd. Spring Ltd and Summer Ltd are incorporated in Bermuda, a tax haven, each with two issued shares of US$1. Autumn Ltd is incorporated in Hong Kong, with an issued share capital of $2 (two shares of HK$1 each).

Mr. Pang has acquired three non-residential properties (at $10 million each) in Hong Kong via the three companies. The group structure is as follows:



Mr. Pang is now considering the following arrangements:

(i) Spring Ltd sells Property A to Summer Ltd at $1.

(ii) Autumn Ltd lets Property C to Summer Ltd for twenty years for a lump sum payment of $10 million. The lease will be an operating lease and the lease premium will be recognised as income on a straight line basis over the lease term according to Hong Kong Accounting Standard 17.

Required:

(a) Advise Mr. Pang on the stamp duty implications of the proposed property transactions. **(4 marks)**

(b) Advise Mr. Pang on the profits tax and property tax implications relating to the lease arrangement of Property C. **(4 marks)**

(c) Suggest two restructuring plans to Mr. Pang to make Summer Ltd the sole owner of all three properties. **(12 marks)**

(Total = 20 marks)

Mr. Au

31 minutes

Discuss and calculate, if applicable, whether stamp duty is payable in the following circumstances:

(a) Mr. Au, at the request of his son, will swap his own residential property at Ma On Shan at a market value of $8 million with his son's residential property at North Point at a market value of $5 million. Both Mr. Au and his son agreed that the swap is to be executed without any cash payment. **(4 marks)**

(b) Mr. Fischer, a Hong Kong resident, owns 80% of the shares in A Ltd. A Ltd currently owns a 95% shareholding of B Ltd as well as a 95% shareholding of C Ltd. It is also noted that C Ltd has owned a 95% shareholding of D Ltd. A Ltd, C Ltd and D Ltd are all incorporated in the British Virgin Islands whilst B Ltd is incorporated in Hong Kong. It is proposed that a portfolio of securities listed in the stock market of Hong Kong currently held by D Ltd with a market value of $6 million be transferred to B Ltd at the current market value and be settled by cash for the purpose of assets re-alignment. **(5 marks)**

(c) Dornbusch Ltd would like to enter into a lease contract with a landlord to lease a shop premises for conducting a retail business selling sports shoes. Monthly rental of the shop premises consists of (i) a fixed rental of $100,000 per month, and (ii) variable rental at 15% of the monthly turnover of Dornbusch Ltd derived from the retailing business conducted in the shop premises. Both parties agree that the minimum amount of variable rental is $400,000 and the maximum amount is $1,200,000. The rental period is fixed for 1 year effective from 1 January 2013. In addition, Dornbusch Ltd is also required to pay a premium of $300,000 to the landlord upon execution of the lease agreement. **(5 marks)**

(d) Mr. Kam owns the entire shares in a Hong Kong company, Norton Ltd. The company does not have any assets or liabilities, but it holds a residential property located at Shatin with a market value of $5 million. Mr. Kam is considering winding up the company and taking back the property after liquidation in order to save the costs of maintaining the company in future. **(3 marks)**

(Total = 17 marks)

HKICPA December 2011 (Amended)

XYZ Ltd

16 minutes

XYZ Ltd is a Hong Kong company incorporated in 1960 by its 90% holding company, ABC Inc, a company incorporated in Country X. As part of a group restructuring exercise, XYZ Ltd will be transferred by ABC Inc to its wholly owned subsidiary, NEWCO, a company incorporated in country Y.

The net asset value of XYZ Ltd as at 31 December 2012 was $100 million.

Required:

(a) Advise on the Hong Kong tax implication of the proposed transfer of the shares in XYZ Ltd to NEWCO. **(5 marks)**

(b) If XYZ Ltd has a 100% subsidiary, SZCO, in Shenzhen, China, explain whether your advice in (a) above would be different. **(1 mark)**

(c) If SZCO is to be transferred to NEWCO (instead of transferring XYZ Ltd), advise on the Hong Kong tax implications. **(1 mark)**

(d) If XYZ Ltd has brought forward an agreed tax loss of $10 million, explain whether this loss would be preserved. **(2 marks)**

(Total = 9 marks)

HKICPA June 2002 (Amended)

Douglas **20 minutes**

Douglas was the shareholder and managing director of E Ltd, a company incorporated in Hong Kong. Douglas earned a salary of $100,000 per month from E Ltd. Due to the company's good performance in the year ended 31 March 2012, he was also paid a dividend of $2 million. In July 2012, Douglas made use of the dividend as a down payment to purchase his first flat, which cost $4 million, whilst the remainder of the consideration was financed by a mortgage loan.

Due to the default of various European customers, E Ltd encountered a serious liquidity problem in August 2012. As the banker of E Ltd declined to increase E Ltd's credit limit, Douglas sold the new flat for $5 million in September 2012 and advanced part of the net sale proceeds of $2 million to E Ltd as a shareholder's loan.

As a result of the unsatisfactory business prospects, Douglas sold his shares in E Ltd to Frank at $11 million, which was equivalent to the net asset value of the relevant shares, in December 2012. As part of an integral transaction of this sale, Frank also undertook to make a loan to E Ltd to enable it to repay the above shareholder's loan in February 2013.

Required:

(a) Discuss whether the profits derived by Douglas from the sale of his property are chargeable to profits tax. **(5 marks)**

(b) Explain how the purchase and sale of the shares in E Ltd between Douglas and Frank are chargeable to stamp duty (Note: Computation of stamp duty is required). **(6 marks)**

(Total = 11 marks)

HKICPA June 2012 (Amended)

Dr. A **11 minutes**

Dr. A entered into an agreement to purchase a residential flat, Flat C, as the sole owner on 1 February 2012. Under the agreement, Dr. A was required to settle the consideration within one year. On 1 March 2012, Dr. A obtained an equitable mortgage loan to pay part of the consideration. He commenced to repay the loan (with interest of $10,000 per month) on 1 April 2012. On 1 November 2012, Dr. A settled the balance of the consideration, and nominated his wife, Mrs. A, to take up the assignment of Flat C and the related mortgage loan with him as joint tenants. The relevant assignment and mortgage deed were also executed on that day.

Dr. A also entered into an agreement to purchase another residential flat, Flat D, as the sole owner on 1 March 2012. He nominated Company E to take up the assignment of Flat D on 1 October 2012. Company E is a corporation of which Dr. A and Mrs. A are the only shareholders and directors. It incurred a significant loss from share dealing in 1997, and has been left dormant since then.

Required:

Explain whether and, if so, how the following instruments are chargeable with special stamp duty:

(a) the agreement dated 1 November 2012 under which Dr. A nominated Mrs. A to take up the assignment of Flat C with him as joint tenants. **(2 marks)**

(b) the agreement dated 1 October 2012 under which Dr. A nominated Company E to take up the assignment of Flat D. **(4 marks)**

(Total = 6 marks)

HKICPA December 2012 (Amended)

Further reading

Suggested References

When studying this topic we suggest the following references:

Primary References

Advanced Taxation in Hong Kong, Pearson (Chapter 20)

Hong Kong Master Tax Guide, CCH Hong Kong Ltd (Chapter 14)

Hong Kong Taxation – Law & Practice, Chinese University Press (Chapter 12)

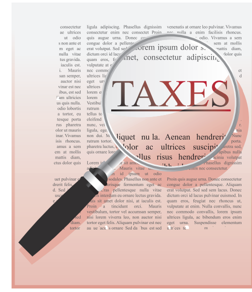
Hong Kong Taxation and Tax Planning, Pilot Publishing Co Ltd (Chapters 36 to 41)

Stamp Duty Ordinance

SOIPN 1 (Revised)	Stamping of agreements for sale and purchase of residential property
SOIPN 2 (Revised)	Relief for stock borrowing and lending transactions
SOIPN 3	Deemed consideration under s.24 of the SDO
SOIPN 4	Deemed sale and purchase under s.19(1E) of the SDO
SOIPN 5 (Revised)	Special stamp duty

Supplementary Reference

Hong Kong Tax Manual, CCH Hong Kong Ltd (Para 40)



Part E

Tax planning and tax investigation

Tax planning is of course one of the challenges faced by tax practitioners. Regard has to be given to the various anti-avoidance provisions in the Inland Revenue Ordinance. Important anti-avoidance provisions are the focus of many recent tax cases in the Court of Final Appeal. Dicta of the judges shed light on their interpretation and application. Tax planning is no easy task for the tax advisor. If proper consideration does not take place at the planning stage, the taxpayer may suffer penalties, or may even be subject to a tax investigation.

chapter 9

Introduction to tax planning

Topic list

1 Overview

2 *Ramsay* principle

- 2.1 Application of the *Ramsay* principle in Hong Kong

3 Ethical considerations in tax planning

4 Anti-avoidance provisions under the IRO

- 4.1 Section 61 – Certain transactions and dispositions to be disregarded
- 4.2 Section 61A – Transactions designed to avoid liability to tax
- 4.3 Section 61B – Utilisation of losses to avoid tax
- 4.4 Section 9A – Remuneration under certain agreements treated as income derived from an employment of profit
- 4.5 Service company 'Type II' arrangements
- 4.6 Sections 15(1)(m) & 15A – Transfer of right to receive income
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- 4.8 Sections 16E(8) and 16EA(9) – Commissioner's power to determine the true market value of intellectual property rights
- 4.9 Section 16EC – Deduction under s.16E or 16EA not allowable under certain circumstances
- 4.10 Section 16G(3)(c) – Commissioner's power to determine the true market value of a prescribed fixed asset on sale
- 4.11 Section 16J(4) – Commissioner's power to determine the true market value of environmental protection facilities on sale
- 4.12 Section 18D(2A) – Relevant profit of an old business to be assessed
- 4.13 Section 20 – Liability of certain non-resident persons
- 4.14 Section 20AE – Assessable profits of non-resident persons regarded as assessable profits of resident persons
- 4.15 Section 21A – Computation of deemed assessable profits under s.15(1)(a), (b) or (ba)
- 4.16 Section 22B – Limited partner loss relief
- 4.17 Section 38B – Commissioner's power to determine the true market value of an asset on sale
- 4.18 Section 39E – Depreciation allowances on leased machinery and plant

5 Penalty on tax avoidance cases

6 Practical considerations in tax planning

- 6.1 Operation review
- 6.2 General planning strategies
- 6.3 Misconception
- 6.4 Issues of concern in tax planning
- 6.5 Planning for the overall structure of a business enterprise or a group of companies
- 6.6 Planning for business transactions
- 6.7 Action plan
- 6.8 Implementation and evaluation

7 Advance ruling system

Appendix

- Appendix 1 Tax cases on the application of s.61
- Appendix 2 Tax cases on the application of ss.61 and 61A
- Appendix 3 Tax cases on the application of s.9A
- Appendix 4 Tax cases on the application of DIPN 24

Learning focus

When you propose a tax scheme, you need to consider its implications in full: whether it can be justified commercially, its complexity, the costs and benefits, the interaction with other taxes (stamp duty), and any overseas tax implications. You should also examine whether the scheme conflicts with any anti-avoidance provisions. The importance of the general as well as specific anti-avoidance provisions must be fully understood. Recent case developments should be read thoroughly which shed light on these topics (in particular on s.61A). The costs, including penalties or other implications may outweigh the benefit.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Describe the key aspects of the tax system in Hong Kong		
1.07	**Interpretation of tax statutes**	3
1.07.02	Explain the purposive interpretation and the significance of the *Ramsay* principle	
Tax planning		
2.39	**Anti-avoidance provisions in the IRO**	3
2.39.01	Explain the general and specific anti-avoidance provisions under the IRO	
2.39.02	Discuss the application of the general and specific anti-avoidance provisions under the IRO	
2.39.03	Discuss the tax implications and development of the tax avoidance cases	
2.39.04	Explain deemed employment income under service company 'Type I' arrangement	
2.39.05	Explain and apply DIPN 15 and DIPN 25	
2.40	***Ramsay* principle**	3
2.40.01	Explain the *Ramsay* principle	
2.40.02	Discuss the application of the *Ramsay* principle	
2.40.03	Explain and apply DIPN 15	
2.41	**Offences and penalties**	3
2.41.01	Discuss the exposure to penalty action in tax planning	
2.41.02	Explain and apply DIPN 15	
2.42	**Advance ruling**	2
2.42.01	Describe the advance ruling system	
2.42.02	Explain and apply DIPN 31	

		Competency level
2.44	**Hong Kong tax planning**	3
2.44.01	Identify issues on tax planning opportunities for individuals, partnerships, unincorporated businesses and corporations and group restructuring	
2.44.02	Recognise tax-efficient ways to structure remuneration packages for employees and employment arrangements	
2.44.03	Identify tax planning opportunities for individuals under contracts of service or contracts for service	
2.44.04	Identify strategies to minimise or defer the tax liability of a group of companies by diverting income, increasing allowable deductions, and altering the period of income recognition	
2.44.05	Evaluate alternative business operations and transactions from a tax perspective	
2.44.06	Evaluate the tax implications of setting up a holding company, subsidiary or a branch in Hong Kong for international tax planning considerations	
2.44.09	Identify the tax planning opportunities under the Arrangement	
2.44.10	Explain and apply DIPN 24, 45, 46 and 48	

1 Overview

Topic highlights

Tax planning may be described as the process of organising the affairs of a taxpayer in a legal and commercially realistic manner so as to reduce or defer the tax liability of the taxpayer.

Reducing the amount of tax payment means increasing disposable income. On the other hand, delaying tax payment means preserving a pool of fund without resorting to external borrowing. The said sum may then be deployed for other gainful use without incurring borrowing cost.

Tax planning involves the legitimate arrangement of a taxpayer's affairs. One who avoids tax does not conceal or misrepresent. He shapes events to reduce or eliminate tax liability before any tax liabilities arise and makes full and complete disclosure of events and transactions.

Tax evasion, on the other hand, involves deceit, subterfuge, camouflage, concealment, some attempt to colour or obscure events, or making things seem other than they are.

Tax planning is a management function. For business investors, tax is a cost or an expense similar to office rent or staff salaries. Management is obliged to reduce the incidence of tax by lawful means for the ultimate benefit of the investors.

Proper tax planning is a continuous process, not hasty remedial action at the end of the fiscal year. Year-end planning should be an overall review to verify that all necessary steps have been taken. There is no magic plan applicable to all taxpayers. Tax planning must be adapted to each taxpayer's particular needs. The possible cost associated with potential tax appeals and litigation should be considered in formulating tax planning strategies. Planning strategies that clearly conform to the law would mean savings of time and resources associated with tax disputes.

Taxpayers are free to choose how, when and where to do an act so as to attract the lowest amount of tax in a legal way. However, they should be cautious so as not to infringe upon any of the anti-avoidance provisions under the IRO. They should also avoid inserting non-commercial or self-cancelling steps in a transaction to circumvent the provisions of the IRO.

In *IRC v Duke of Westminster* [(1936) AC1], Lord Tomlin said: *"Every man is entitled, if he can, to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be".* This has then been regarded as the maxim of tax planners.

DIPN 15 explains the IRD's view of the *Westminster* principle in para 46(b):

> *"Where a taxpayer could have achieved a particular financial result in two different ways, one of which would have attracted tax and the other not, there being no abnormal features in either event, the Assistant Commissioner will not contend that an assessment should be made on the basis that the taxpayer followed a method which would have attracted tax. In other words, the Department accepts that a taxpayer is not obliged to maximise his tax liability."*

The following are some extracts from the cases decided in the UK in connection with tax planning. Although the tax legislation in the HKSAR is different from that in the UK, reference is often made to these cases where circumstances warrant.

2 *Ramsay* principle

Topic highlights

Although the tax legislation of Hong Kong is different from that of the UK, reference is often made to relevant UK cases where circumstances warrant it.

In *W T Ramsay Ltd v IRC* [(1982) AC300], Lord Wilberforce said: *"This is a cardinal principle but it must not be overstated or over-extended. While obliging the court to accept documents or transactions, found to be genuine, as such, it does not compel the court to look at a document in blinkers, isolated from any context to which it properly belongs. If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded: to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination that may be disregarded."* The so-called '*Ramsay* principle' developed from that case enables the court to disregard certain transactions if these circular or self-cancelling transactions were entered into for the sole or dominant purpose of obtaining a tax benefit.

The *Ramsay* approach was confirmed or even expanded in *Furniss v Dawson* [(1984) ALL ER530] where the House of Lords held *"In* Ramsay *the House has to consider an elaborate and entirely artificial scheme for avoiding liability to tax. Viewed as a whole, it was self-cancelling. In the present case the scheme was much simpler, and it was not self-cancelling; on the contrary, it had ….. 'enduring legal consequences'. But while the cases differ in that respect, it is not a sufficient ground for distinguishing the present case from Ramsay. The true principle of the decision in Ramsay was that the fiscal consequences of a preordained series of transactions, intended to operate as such, are generally to be ascertained by considering the result of the series as a whole, and not by dissecting the scheme and considering each individual transactions separately. …. First, there must be a preordained series of transactions, or, if one likes, one single composite transaction. This composite transaction may or may not include the achievement of a legitimate commercial (i.e. business) end. … Second, there must be steps inserted which have no commercial (business) purpose apart from the avoidance of a liability to tax …. If those two ingredients exist, the inserted steps are to be disregarded for fiscal purposes. The court must then look at the end result. Precisely how the end result will be taxed will depend on the terms of the taxing statute sought to be applied."*

The *Ramsay* principle was again applied in *IRC v McGuckian* [(1997) STC908]. The House of Lords ignored a step (an assignment of the right to receive income) inserted solely for the purpose of avoiding the income tax liability of Mr McGuckian.

However, Courts in Australia and Canada have found that the *Ramsay* principle (i.e. the fiscal nullity principle) does not apply when the taxation legislation contains anti-avoidance measures (*FC of T v Patcorp Investments Ltd* (76 ATC 4225); *Oakey Abattoir Pty Ltd v FC of T* (84 ATC 4718); *Stubart Investments Ltd v R* [(1984) DTC 6305]).

2.1 Application of the *Ramsay* principle in Hong Kong

The 'fiscal nullity or '*Ramsay'* principle enables the Court to disregard a pre-ordained series of transaction containing steps that are self-cancelling or without commercial substance. It applies when:

(a) there is a pre-ordained series of transactions or a single composite transaction; and

(b) there are steps inserted which have no commercial or business purpose apart from the avoidance of a liability to tax.

'Pre-ordained' means there was a practical likelihood that all the steps in the composite transaction must have been determined when the initial steps were carried out.

If the above conditions exist, the inserted steps are to be disregarded for fiscal purposes and the court must then look at the end result.

The applicability of the fiscal nullity principle in Hong Kong was considered by the BOR in *D52/86* whereby the BOR found that the Hong Kong situation is similar to that in Australia and adopted the reasoning of *Patcorp Investments* and *Oakey Abattoir*. In view of the availability of general anti-avoidance provisions in the IRO, the fiscal nullity principle should not be applicable in Hong

Kong for the purposes of the IRO (i.e. profits tax, salaries tax, property tax and personal assessment).

Since there are no specific anti-avoidance provisions in the SDO or Estate Duty Ordinance, the fiscal nullity principle may be applicable in Hong Kong to schemes that have no commercial substance but to avoid stamp duty or estate duty. In *Shiu Wing Ltd and Others v CED* [(2001) 1 HKRC 90-106], the CFA considered the *Ramsay* principle was applicable in Hong Kong to estate duty cases although its decision in that case was in favour of the taxpayer. In *Arrowtown Assets Limited* [(2004) 1 HKRC 90-129], which is a stamp duty case, the CFA opined that *Ramsay* is no more than the established principle of purposive interpretation of statue. Ribeiro PJ took the view that *Ramsay* is a decision that the Court is entitled, for fiscal purpose, to disregard intermediate steps having no commercial purpose as a consequence of an orthodox exercise of purposive statutory construction.

However, the decision of *D52/86* was subsequently overturned. The High Court decision of *CIR v Tai Hing Development Cotton Mill (Development) Ltd* [HCIA 8/2004] and two BOR decisions (*D94/04* and *D97/04* – subsequently the *HIT Finance* and *Hongkong International Terminals* cases) confirmed that the *Ramsay* principle can be applied side by side with ss.61 and 61A (see **sections 4.2 and 4.3** below for a discussion of ss. 61 and 61A). These cases took the view that the 'purposive statutory interpretation' deals with the question whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction viewed realistically.

The IRD takes the view that this principle is regarded as an approach in statutory interpretation, a purposive interpretation, in a number of English and Hong Kong cases such as *Arrowtown* as summarised in DIPN 15. The principle as explained by Ribeiro PJ in *Arrowtown* was adopted by the House of Lords in *Barclays Merchantile Business Finance Limited v Mawson* [(2005) STC 1]:

> *"[T] he driving principle in the* Ramsay *line of cases continues to involve a general rule of statutory construction and an unblinkered approach to the analysis of the facts. The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically."*

In applying the provisions laid down in the IRO, the Commissioner is entitled to adopt this purposive interpretation of the statutory provisions to the facts viewed realistically. Being an interpretation approach, the *Ramsay* principle can co-exist and operate alongside the general anti-avoidance provisions. Under this principle, the Commissioner in appropriate cases is thus entitled to look at the substance of the transactions and not just their legal form. If the purpose of intermediate steps in the composite transaction was fiscal, the Commissioner would disregard them and bring the composite transaction within a charging provision.

Although the anti-avoidance rules in the other jurisdictions are not outlined here, these rules must also be carefully evaluated, especially when cross-border business transactions are involved.

3 Ethical considerations in tax planning

Topic highlights

To promote and maintain a high standard of professional conduct and to give guidance to its members, the Hong Kong Institute of Certified Public Accountants ('the Institute') issues statements on various aspects of professional ethics.

Tax is a major source of the government's income. To preserve the welfare of the community, taxpayers (and also professional accountants) should act honestly in handling their (or their clients') tax affairs.

Being members of a professional body (such as the Institute), expectations from the public on the conduct of professional accountants are high. A professional accountant owes duties to the public,

including those who retain or employ him/her, to the profession itself and also to the other members of the professional body.

A professional accountant is required to comply with the following Fundamental Principles as outlined in the Institute's 'Code of Ethics for Professional Accountants' (section 100.5):

(a) *Integrity*

A professional accountant should be straightforward and honest in all professional and business relationships.

(b) *Objectivity*

A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

(c) *Professional competence and due care*

A professional accountant should maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.

(d) *Confidentiality*

A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.

(e) *Professional behaviour*

A professional accountant should comply with relevant laws and regulations and avoid any action that discredits the profession.

The Institute has also specified Ethics in Tax Practice in the 'Code of Ethics for Professional Accountants' (section 430) as follows:

Fundamental Principles

The fundamental principles to be observed when developing ethical requirements relating to tax practice include all five Fundamental Principles by which a member is governed in the conduct of his professional relations with others.

Development of the Fundamental Principles

(1) A member rendering professional tax services is entitled to put forward the best position in favour of his client, provided he can render the service with professional competence, it does not in any way impair his standard of integrity and objectivity, and is in his opinion consistent with the law. He may resolve doubt in favour of his client if in his judgment there is reasonable support for his position.

(2) A member should not hold out to clients the assurance that the tax return he prepares and the tax advice he offers are beyond challenge. Instead, he should ensure that his clients are aware of the limitations attaching to tax advice and services so that they do not misinterpret an expression of opinion as an assertion of fact.

(3) A member who undertakes or assists in the preparation of a tax return should advise his client that the responsibility for the content of the return rests primarily with the client. The member should take the necessary steps to ensure that the tax return is properly prepared based on the information received from the client.

(4) Tax advice or opinions of material consequence given to a client should be recorded either in the form of a letter to the client or in a memorandum for the files.

(5) A member must not associate himself with any return or communication which he has reason to believe:

(a) contains a false or misleading statement;

(b) contains statements or information furnished by the client recklessly or without any real knowledge of whether they are true or false; or

(c) omits or obscures information required to be submitted and such omission or obscurity would mislead the IRD.

If any of the above situations prevails, the member's responsibility is to resign from acting as the client's tax representative. Having resigned the member should:

(a) inform the IRD that he has withdrawn his services.

(b) give no further information to the authorities without the consent of the client, unless required to do so by law.

(6) A member may prepare tax returns involving the use of estimates if such use is generally acceptable or if it is impractical under the circumstances to obtain exact data. When estimates are used, they should be presented as such in a manner so as to avoid the implication of greater accuracy than exists. The member should be satisfied the estimated amounts are reasonable under the circumstances.

(7) In preparing a tax return, a member ordinarily may rely on information furnished by his client provided that the information appears reasonable. Although the examination or review of documents or other evidence in support of the client's information is not required, the member should encourage his client to provide such supporting data, where appropriate.

In addition, the member:

(a) should make use of his client's returns for prior years whenever feasible.

(b) is required to make reasonable inquiries where the information presented appears to be incorrect or incomplete.

(8) The member's responsibility when he learns of a material error or omission in a client's tax return of a prior year (with which he may or may not have been associated), or of the failure of a client to file a required tax return, is as follows:

(a) He should promptly advise his client of the error or omission and recommend that the client make disclosure to the IRD. Normally, the member is not obligated to inform the IRD, nor may he do so without his client's permission.

(b) If the client does not correct the error:

(i) the member should inform the client that he cannot act for him in connection with that return or other related information submitted to the authorities;

(ii) the member should consider whether continued association with the client in any capacity is consistent with his professional responsibilities; and

(iii) if the member concludes that he can continue with his professional relationships with the client, he should take all reasonable steps to assure himself that the error is not repeated in subsequent tax returns.

(c) If because of the error or omission, the member ceases to act for the client, in these circumstances, the member should advise the client of the position before informing the authorities of his having ceased to act and should give no further information to the authorities without the consent of the client, unless required to do so by law.

Failure to follow the above guidance does not of itself constitute misconduct, but the member concerned may be at risk of having to justify his actions in answer to a complaint. It is advisable that all tax representatives (not necessarily just members of the Institute) should refer to the above guidance in rendering tax services to their clients.

4 Anti-avoidance provisions under the IRO

Topic highlights

The IRD has been using anti-avoidance provisions, both specific and general, to tackle tax avoidance schemes.

This section set out the relevant anti-avoidance tax legislations for consideration during the process of organising one's tax affairs. These provisions must be carefully reviewed and taken into account together with other relevant tax rules.

The following are the major anti-avoidance provisions under the IRO:

Section	Scope	Enforced by
61	Certain transactions and dispositions to be disregarded	Assessor
61A	Transactions designed to avoid liability for tax	Assistant Commissioner
61B	Utilisation of losses to avoid tax	Commissioner *
9A	Remuneration under certain agreements treated as income derived from an employment of profit	Not specified
15(1)(m) & 15A	Transfer of right to receive income	Not specified
16(2), (2A), (2B) & (2C)	Deduction of interest expenses	Not specified
16E(8) and 16EA(9)	Commissioner's power to determine the true market value of intellectual property rights	Not specified
16EC	Deduction under s.16E or 16EA not allowable under certain circumstances	Not specified
16G(3)(c)	Commissioner's power to determine the true market value of a prescribed fixed asset on sale	Commissioner *
16J(4)	Commissioner's power to determine the true market value of environment protection facilities on sale	Commissioner *
18D(2A)	Relevant profit of an old business to be assessed	Not specified
20	Liability of certain non-resident persons	Not specified
20AE	Assessable profits of non-resident persons regarded as assessable profits of resident persons	Not specified
21A	Computation of deemed assessable profits under ss.15(1)(a), (b) or (ba)	Not specified
22B	Limited partner loss relief	Not specified
38B	Commissioner's power to determine the true value of an asset on sale	Commissioner *
39E	Depreciation allowances on leased machinery and plant	Not specified

* It is not necessary for the Commissioner to personally enforce ss.61B, 16G(3)(c), 16J(4) and 38B. Delegation of power is possible.

Sections 61 and 61A are general anti-avoidance provisions. Other sections are specific anti-avoidance provisions.

4.1 Section 61 – Certain transactions and dispositions to be disregarded

Pursuant to s.61, where an assessor is of the opinion that

(a) any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious, or that

(b) any disposition is not in fact given effect to;

he may disregard any such transaction or disposition and the person concerned shall be assessed accordingly.

Key terms

'Artificial' is not defined in the IRO. In general, an artificial transaction refers to an unusual transaction that is 'not natural or not ordinary', or a transaction which has been carried out but is commercially unrealistic.

'Fictitious' also is not defined in the IRO. A fictitious transaction refers to a transaction which is 'not genuine or unreal', or a transaction which the parties to it never intend to make or carry out (i.e. a 'sham').

A transaction which has been effectively carried out cannot be fictitious but can be artificial.

Commercial realism can be one of the considerations for deciding artificiality (see *Cheung Wah Keung v CIR* [(2002) HKRC 90-116]), and it is necessary to scrutinise the terms of the particular transaction to be impugned and the circumstances in which it was made and carried out.

DIPN 15 (Revised) provides guidance on the application of s.61.

Cases on the application of s.61

The application of s.61 was examined in the following cases:

Taxpayer	Subject matter	Reference
Rico Internationale Ltd	Genuine commercial purpose	(1965) 1 HKTC 229
Kum Hing Land Investment Co Ltd	Genuine commercial purpose	(1967) 1 HKTC 301
Douglas Henry Howe	Genuine commercial purpose	(1977) 1 HKTC 936
Stanley So & Co	Genuine commercial purpose	(2004) 1 HKRC 90-131

These cases are discussed in **Appendix 1**.

4.2 Section 61A – Transactions designed to avoid liability to tax

The scope of s.61 has been considered to be narrow as it only applies to artificial or fictitious transactions or dispositions not in fact carried out; and that the only action that can be taken by the IRD is to disregard such transactions or dispositions.

Section 61A was enacted in 1986 to extend the scope of the anti-avoidance provisions to any transaction entered into or effected after 13 March 1986. For s.61A to apply,

(a) there must be a transaction as defined;

(b) the transaction has or would have had the effect of conferring a tax benefit on a person (the relevant person); and

(c) having regard to the following matters, it would be concluded that the sole or dominant purpose of entering into that transaction was to enable the relevant person, either alone or in conjunction with other persons, to obtain a tax benefit.

The seven specific matters under s.61A(1) are:

(1) the manner in which the transaction was entered into or carried out;

(2) the form (the legal rights and obligations created) and substance (the practical end result) of the transaction;

(3) the result in relation to the operation of the IRO that, but for s.61A, would have been achieved by the transaction;

(4) any change in the financial position of the relevant person that has resulted, will result, or may reasonably be expected to result, from the transaction;

(5) any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant person, being a change that has resulted or may reasonably be expected to result from the transaction;

(6) whether the transaction has created rights or obligations which would not normally be created between persons dealing with each other at arm's length under a transaction of the kind in question; and

(7) the participation in the transaction of a corporation resident or carrying on business outside Hong Kong.

Not all matters are equally relevant in every case, and do not have equal weight; but all the seven matters have to be considered before a conclusion on the purpose of the taxpayer may be reached.

Where s.61A(1) applies, the powers conferred on an assessor in connection with assessments will have to be exercised by the assistant commissioner. The assistant commissioner may raise an assessment on the relevant person:

(a) as if the transaction or any part thereof had not been entered into or carried out (s.61A(2)(a)); or

(b) in such other manner as he considers appropriate to counteract the tax benefit which would otherwise be obtained (s.61A(2)(b)); including

 (i) making adjustments to assessments for years subsequent to the year of assessment in which the transaction was entered into.

 (ii) making corresponding adjustments to assessments of other persons affected by the transaction.

However, the Commissioner would not be entitled to make an assessment on the hypothesis that the taxpayer had entered into an alternative transaction which attracted the highest rate of tax. He may adopt the hypothesis which the evidence suggests was most likely to have been the transaction if the taxpayer had not been able to secure the tax benefit (the **'appropriate alternative hypothesis'**): see *CIR v Tai Hing Cotton Mill (Development) Ltd* [(2008) HKRC 90-198].

Key terms

'Tax benefit' is defined in s.61A(3) as 'the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof'.

'Transaction' is defined in s.61A(3) to include 'a transaction, operation or scheme whether or not such transaction, operation or scheme is enforceable, or intended to be enforceable, by legal proceedings'.

'Sole or dominant purpose' is not defined in the IRO. 'Sole' is defined in the Oxford Dictionary as 'one and only' and 'dominant' is defined as 'occupying a commanding position'. A sole purpose is therefore the only purpose for entering into a transaction or an arrangement whereas a dominant purpose is an 'overwhelming' purpose (not just the main or principal purpose).

The Commissioner has indicated that where there is a genuine commercial purpose for a particular transaction, the IRD will not attempt to apply s.61A. Whether a transaction is in fact for genuine

commercial reasons will depend on the facts and circumstances relating to the transaction. As the burden of proof is on the taxpayer to support the commerciality of an arrangement, the taxpayer must be able to provide contemporaneous and historical documentation relating to the particular transaction to support his claim.

Cases on the application of ss.61 and 61A

The application of ss.61 and 61A was examined in the following cases:

Taxpayer	Subject matter	Reference
Yick Fung Estates Limited	Genuine commercial purpose	(2001) HKRC 90-112
Cheung Wah Keung	Genuine commercial purpose	(2002) HKRC 90-116
Asia Master Ltd	Genuine commercial purpose	(2006) HCAL 114/2005
Tai Hing Cotton Mill (Development) Ltd	Genuine commercial purpose	(2008) HKRC 90-198
HIT Finance Ltd	Genuine commercial purpose	(2008) HKRC 90-199
Shui On Credit Company Ltd	Genuine commercial purpose	(2008) HCIA 2/2007 & (2008) CACV 85/2008
Ngai Lik Electronics Company Ltd	Genuine commercial purpose	(2008) 1 HKRC 90-200 & (2009) 1 HKRC 90-217

These cases are discussed in **Appendix 2**.

DIPN 15 (Revised) provides guidance on the application of s.61A, including procedures on application for an advance ruling.

Example 1

A Ltd is a leading manufacturer of electronic products in Hong Kong. In 1971, A Ltd acquired a plot of land in Yuen Long, New Territories ('the Land'), and erected thereon a factory for production. Due to the relocation of its manufacturing process to the Mainland, the factory in Yuen Long had been left vacant since 2009. In 2010, A Ltd resolved to put the Land in valuable use.

B & Co, a tax and business advisory firm, was consulted by A Ltd for the above business plan. In 2010, following the advice of B & Co, A Ltd established a wholly-owned subsidiary, C Ltd, in Hong Kong with a view to redeveloping the Land as a residential complex. A Ltd contracted to sell the Land to C Ltd at a consideration of $200 million plus 60% of the net profits realised by C Ltd from the redevelopment. The fair market value of the Land at that time was $500 million.

In the year ended 31 December 2012, the redevelopment of the Land was completed and C Ltd earned net profits of $1,000 million from the sale of residential units. Pursuant to its contract with A Ltd, C Ltd paid a further sum of $600 million as the consideration for the Land.

Last week, C Ltd received an enquiry from the IRD in respect of its deduction of the land cost of $800 million for the year of assessment 2012/13. C Ltd engaged E & Co to handle the enquiry.

Required:

Assume that you are the tax manager of E & Co, who is assigned with this enquiry case, draft an advice letter to C Ltd analysing the deductibility of the above land cost under ss.16, 17 and 61A.

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Solution

[Date]
C Ltd
[Address]
[Our reference]

Dear Sir,

We refer to your recent engagement with this firm to handle the enquiry raised by the IRD. As I understand, the enquiry concerned the deductibility of the land cost of $800 million. We summarise below our understanding and comments thereon for your information.

The Facts

(1) The land cost was incurred in respect of the Land which was acquired from A Ltd, the parent company of C Ltd.

(2) The cost included two elements, namely the initial cost of $200 million and the variable cost of 60% of the net profits realised by C Ltd from the redevelopment of the Land. According to the information supplied by you, the variable cost amounted to $600 million.

(3) At the time of acquisition by C Ltd, the market value of the Land was $500 million.

Issues raised

Whether, and if so, to what extent the above land cost is deductible for profits tax purposes?

The Law

(1) Sections 16 and 17 of the IRO

Section 16(1) allows deductions of any outgoings and expenses to the extent they were incurred in the production of chargeable profits. Section 17(1)(b) prohibits deductions of any expenses which were not expended for the purpose of producing chargeable profits.

(2) Section 61A of the IRO

(a) Section 61A provides that if it can be concluded that a transaction was entered into or carried out for the sole or dominant purpose of enabling the relevant person, either alone or in conjunction with others, to obtain a tax benefit, the person shall be assessed as if the transaction or any part thereof had not been entered into or carried out, or in such other manner as appropriate to counteract the tax benefit.

(b) In *CIR v Tai Hing Cotton Mill (Development) Limited* [(2008) HKRC 90-198] , the CFA held that if the effect of a transaction was that *"the liability to tax is less than it would have been on some other appropriate hypothesis"*, the taxpayer concerned would be regarded as having obtained a tax benefit. In that case, the Court held that the Commissioner could adopt the market value to determine whether the taxpayer had obtained a tax benefit from its acquisition of a land.

Our comments

Based on the above statutory provisions and legal principles, our comments on the deductibility of the land cost are as follows:

(a) The land cost included a variable dependent on the profits realised by C Ltd from the redevelopment of the Land, making the total land cost far in excess of the market value upon acquisition. The Commissioner may consider that the payments which exceeded the market value of the Land were not expenses incurred in the production of the profits from the redevelopment project but an appropriation of the profits. They should be disallowed pursuant to ss.16(1) and 17(1)(b).

(b) Alternatively, the Commissioner may invoke s.61A and take the view that the sole or dominant purpose of the transaction, being the purchase of the Land from A Ltd in accordance of the agreed terms, was to confer a tax benefit on C Ltd by enabling it to deduct a land cost more than it could have done if the sale had been at market value. In our view, it is clearly open for the Commissioner to arrive at this conclusion, having regard to the following features of the transaction:

   (a) A Ltd and C Ltd were parent and subsidiary. As held in *Tai Hing*, they were "the same enterprise under the same direction in economic terms" and plainly not dealing at arm's length.

   (b) The considerations for the Land consisted of an element for the appropriation of the profit derived from the redevelopment project. It was unusual for companies to have entered into such an agreement if they were dealing at arm's length.

   (c) The ultimate considerations paid by C Ltd in respect of the Land were commercially unrealistic and grossly excessive when compared with the market value.

   (d) The above circumstances are strong indicators that the purpose of the transaction is to mop up a large portion of C Ltd's profits and transfer them tax free to A Ltd.

In order to counteract the tax benefit conferred on C Ltd, the Commissioner is entitled to restrict the amount of land cost allowable to C Ltd to the market value of the Land.

Conclusion

The above only provides our initial assessment of the deductibility of the land cost. It may not reflect the actual determination by the Commissioner, who may take a different view if any additional facts of the case are later provided for his consideration. We are pleased to advise further on the issues should this be required.

We trust the above will be of assistance to you. Should you have any questions, please feel free to contact me at [telephone number] or Mr Y, Tax Manager of this office, at [telephone number].

Yours sincerely,

Partner
E & Co.

HKICPA May 2010 (Amended)

Self-test question 1

X Ltd was set up in 2010 in the Cayman Islands and has had only one transaction, in the year 2012, relating to the receipt of a commission from Y Ltd, its parent company. Since then, X Ltd has remained dormant and inactive. X Ltd has not filed any tax return in Hong Kong.

Y Ltd has been trading in Hong Kong for many years. There has been no trading transaction between Y Ltd and X Ltd except for the above-mentioned commission paid in the year 2012. The payment of commission to X Ltd was made upon the instruction of the managing director of Y Ltd, with the objective of reducing the tax liability of Y Ltd. A commission agreement was drawn up to effect the transaction.

Required:

Explain the tax implications of the transactions in terms of:

(a) the chargeability to Hong Kong tax of X Ltd; and

(b) the deductibility of the commission to Y Ltd.

(The answer is at the end of the chapter)

4.3 Section 61B – Utilisation of losses to avoid tax

Section 61B was enacted in 1986 to deter arrangements in which a profit making company purchased the shares in a company with carry-forward tax losses and then the profit making company attempted to utilise such available tax losses by diverting profits to the loss company.

Section 61B applies if:

(a) a change in shareholding in a corporation has been effected after 13 March 1986;

(b) the Commissioner is satisfied that as a direct or indirect result of the change in shareholding, profits have been received by or accrued to that corporation during any year of assessment (i.e. not necessarily in the year subsequent to the change); and

(c) utilisation of the loss of that corporation to avoid or reduce the tax liability of that corporation or any other person is the 'sole or dominant' purpose of the change in shareholding.

Key terms

'Effected' means shares are transferred from one person to another. The transferee may or may not be an existing shareholder, and the transferor may or may not continue to be a shareholder.

'Dominant purpose' means the purpose which outweighs all other purposes combined (DIPN 15 (revised), para 54).

In deciding whether profits have been received, the flow of profits before or after the change will be examined in particular with reference to:

(a) nature and conduct of the company's business,

(b) income and expenditure patterns,

(c) management and control, and

(d) background of the party to whom shares were transferred.

The consequence of applying s.61B is that the Commissioner can refuse to allow the set-off of any loss brought forward.

For group reconstructions where there is a change in direct ownership (even though there is no change in ultimate ownership), s.61B will potentially apply if a corporation with losses has other group profitable businesses consolidated into it. However, the IRD has indicated that "it has never been the intention that s.61B should create unnecessary inhibitions to genuine company acquisitions or group restructuring which involve changes in shareholding" (DIPN 15, para 54).

At present, no cases have been decided by the courts of Hong Kong in relation to s. 61B.

DIPN 15 (Revised) provides guidance on the application of s.61B.

Example 2

Metropolitan Express Ltd ('MEL'), a Hong Kong company, provides bus services between Hong Kong and the Mainland. MEL purchased a fleet of 30 buses at a cost of $33 million and started its bus operations in March 2012. In June 2012, MEL started its bus services between Hong Kong and Shenzhen after it had obtained all necessary permission from the Chinese government. All MEL's buses are licensed to operate in the Mainland.

Recently, the management of MEL is considering the following business proposal:

Proposal 1 – To acquire all the shares in Tai Hoi Ltd ('THL'), a business competitor that is in financial difficulties, as part of the capital restructuring of THL for $1 million which is the fair market value of the shares. THL has a substantial tax loss brought forward. Upon obtaining control of THL, MEL will transfer part of its profitable bus operations between Hong Kong and Shenzhen to THL.

The profits tax implications for THL if MEL accepts this business proposal:

THL has a tax loss that can be used to off-set the profits generated from the business transferred from MEL. Normally this tax loss can be used for set-off under s.19C.

However, s.61B may be used by the IRD to question whether the change in shareholding in THL is solely or dominantly for the purpose of obtaining tax benefits. In applying s.61B, one has to look at both the outcome, whether a tax benefit is obtained; and the purpose of the change in shareholding, the reason for the change. If the IRD considers there is no reason for the change, except for the purpose of obtaining tax benefits, s.61B may be invoked and the carry forward of the tax loss for set-off under s.19C will be disallowed.

MEL may succeed in arguing that there are commercial reasons, other than obtaining tax benefits, for the change in shareholdings, such as acquisition by a major competitor and capital restructuring. Hence, obtaining tax benefits is neither the sole nor the dominant purpose for the change in shareholding.

HKICPA September 2001 (Amended)

Self-test question 2

Sad Ltd carries on an import and export business in Hong Kong. In recent years, it incurred substantial losses due to the loss of some major customers. Happy Ltd, one of its customers in Hong Kong, proposes to acquire two-thirds of the total issued shares in Sad Ltd and inject additional working capital into Sad Ltd to finance the expansion of its export business into China.

Required:

(a) Explain the anti-avoidance provision in the IRO relating to the transfer of shares in a loss company.

(b) Discuss the tax implication in respect of the above proposal.

(The answer is at the end of the chapter)

4.4 Section 9A – Remuneration under certain agreements treated as income derived from an employment of profit

Section 9A was enacted in 1995 to deter the use of 'Type I' service companies and trusts to disguise the true employer-employee relationship. The use of Type I service company involves an individual providing his services through a company which he (or his associate) controls, a trust of which he (or his associate) is a beneficiary or a company controlled by such trust. The individual obtains tax benefits through being able to structure employment contracts in a more tax efficient manner than was offered by his employer.

With effect from 18 August 1995, s.9A(1) applies when:

(a) there is an agreement (verbal or written);

(b) services have been carried out under the agreement by an individual (the 'relevant individual') for the 'relevant person' or any other person; and

(c) remuneration for the services has been paid or credited to a corporation or trustee controlled by the relevant individual (directly or indirectly through his associate or trustee).

Where s.9A applies:

(a) remuneration for the services are deemed to be income derived by the service provider (the relevant individual) from employment and chargeable to salaries tax;

(b) the relationship between the payer (the relevant person) and the service provider is treated as employer-employee; and

(c) the payer (the relevant person) must comply with the filing obligations as an employer.

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To avoid double taxation, where s.9A(1) applies:

(a) payment received by the service company or trust is exempt from profits tax; and

(b) salary paid by the service company or trust to the individual is exempt from salaries tax.

Section 9A(1) shall not apply if:

(a) all the specified criteria laid down in s.9A(3) are satisfied; or

(b) the Commissioner exercises his discretion under s.9A(4) that s.9A should not apply when he is satisfied that at all relevant times the carrying out of the services did not, in substance, amount to the holding of an office or employment of profit by the relevant individual with the relevant person (s.9A(4) clearance). The Commissioner will consider if an employment exists by applying the control test, the integration test, the economic reality test and the doctrine of mutuality of obligation (see **chapter 5, section 2.2** on 'Employment' and DIPN 25, para 41 – 44 for a discussion of the tests and the doctrine).

The six criteria under s.9A(3) are as follows:

(1) the agreement does not provide for employment-type fringe benefits (including money in lieu thereof), e.g. annual leave, sick leave, medical benefits etc.;

(2) the relevant individual also provides the same or similar services to other persons;

(3) there is no control or supervision of a kind commonly exercised by an employer;

(4) the remuneration is not paid or credited periodically or calculated on a basis commonly used in employment contracts;

(5) the relevant person has no right to dismiss the relevant individual as if he is an employee; and

(6) the relevant individual is not held out to the public to be an officer or employee of the relevant person.

Where an individual is deemed to be an employee by virtue of s.9A and the payer of the remuneration fails to comply with the employer's obligations, he may not be liable to the penalty ($10,000 per employee) if he relied on a statement in writing given by the individual stating that he is not subject to s.9A; and it was reasonable for the payer to rely upon that statement. The statement is to be given in a form specified by the IRD (see Appendix C of DIPN 25).

If the individual knowingly or recklessly makes the above statement which in a material respect is false or misleading, he shall be guilty of an offence and liable to a fine at level 3 ($10,000): ss.80(1AA) to (1AD).

To reflect the taxation principle that it is not possible for a man to employ himself, exemptions from the application of s.9A are provided under s.9A(7)(b) where:

(a) the relevant person is also the relevant individual, e.g. a sole trader or practitioner uses a company to provide services to his business or practice and is an employee or office holder of that company; or

(b) the relevant person is a partnership and the relevant individual is a partner in that partnership, e.g. a professional partnership has an agreement with a company to provide services to the partnership and the partners are directors or employees of that company.

Such arrangements are 'Type II' service companies and are dealt with in DIPN 24.

DIPN 25 (Revised) provides guidance on the application of s.9A. DIPN 31 (Revised) provides guidance on the application for an advance ruling on s.9A.

Cases on the application of s.9A

The application of s.9A was examined in *D13/06* and *D78/06*; which are discussed in **Appendix 3**.

Example 3

Paul is a medical practitioner engaged by a private hospital ('the Hospital') in Hong Kong as a Senior Medical Officer. The appointment of Paul by the Hospital is through A Ltd, of which Paul is the major shareholder and director.

By Contract B entered into between A Ltd and the Hospital, A Ltd agrees to assign Paul to work at the Hospital. According to Contract B, A Ltd is entitled to a monthly remuneration of $330,000 and an annual bonus. The Hospital makes the payment by auto-pay to the bank account of A Ltd monthly. Paul is entitled to annual vacation leave of 30 days in accordance with Contract B.

By Employment Contract C, Paul is employed by A Ltd to provide consultation services to the Hospital. He is entitled to a monthly remuneration of $100,000 according to Employment Contract C.

The tax position of Paul is as follows:

In the circumstances, s.9A could be applied to the service company arrangement between Paul and the Hospital as the following conditions under s.9A(1) are satisfied:

(a) There is an agreement. Contract B is the relevant agreement.

(b) The Hospital is the 'relevant person' carrying on a business in Hong Kong.

(c) Paul is the 'relevant individual' who is required to provide services to the Hospital in accordance with Contract B.

(d) The remuneration for Paul's services is paid to A Ltd of which Paul has control.

Section 9A, however, will have no application if all the criteria specified by s.9A(3) are duly satisfied. However,

(1) the remuneration provided by the Hospital includes annual leave benefits which are typically associated with employment. Section 9A(3)(a) is not satisfied.

(2) the remuneration is paid monthly which is common for an employment contract. Further, the remuneration also includes an annual bonus which is typical in an employment contract. Section 9A(3)(d) is not satisfied.

Section 9A(4) provides another avenue to take his case out of s.9A(1) if Paul can establish to the satisfaction of the Commissioner that his carrying out of the services is not in substance the holding of an office or employment of profit with the Hospital.

If s.9A applies, Paul is treated as having an employment with the Hospital. The income that A Ltd receives from the Hospital under Contract B should be treated as Paul's income chargeable to salaries tax, and the Hospital will be required to fulfil the obligations as an employer as if Paul is the employee.

However, the remuneration derived by Paul from A Ltd for the provision of services to the Hospital will not be taxable.

HKICPA February 2009 (Amended)

Self-test question 3

Richard was the project manager of Chung Kong Property Ltd ('CKPL'), a Hong Kong company which conducts a property development business in Hong Kong. His main responsibility was to procure materials used in the property development projects of CKPL and to monitor the progress of these projects.

On 31 December 2012, Richard's employment with CKPL was terminated. In January 2013, he started his own business through a company incorporated in the British Virgin Islands, Leeson Ltd ('LL'). LL is wholly owned by Richard, and he appointed himself the general manager of LL.

LL was formed to act as the middleman between the overseas suppliers of building materials and Hong Kong companies, including CKPL. Fees from overseas suppliers are the main source of revenue of LL. LL also made a separate contract with CKPL under which Richard would monitor some development projects of CKPL in Hong Kong. Richard performed all his services for LL in Hong Kong.

Required:

Explain whether s.9A is applicable to the relationship between LL and CKPL and the consequences if this section is applicable.

HKICPA June 2002 (Amended)

(The answer is at the end of the chapter)

4.5 Service company 'Type II' arrangements

'Type II' arrangements involve the use of service companies by unincorporated businesses ('UB'). Service companies typically provide the UB with premises and administrative services in exchange for a management fee which is generally deductible by the UB. Proprietors or partners of the UB would be employees or directors of the service company and receive remuneration from the service company. Such remuneration could be structured to take advantage of the generally favourable tax treatment of non-cash remuneration under salaries tax which would not otherwise be available to the UB.

After much lobbying, such arrangements would be tolerated by the IRD within limit. DIPN 24, issued in August 1995, outlines the terms under which such arrangements will be accepted and warns that arrangements outside those guidelines may be challenged under s.16(1) or ss.61 and 61A. The guidelines for acceptable arrangements are as follows:

(a) Payment of management fee must be on an arm's length basis and properly documented.

(b) The agreement must be reduced to writing, be properly executed and deal with all relevant details, such as the relevant services, the basis on which fees are to be paid and the period covered by the agreement, etc.

(c) Minutes of meetings approving the arrangement, invoices and receipts for payments, bank records and employment contracts must be properly kept.

(d) The maximum allowable management fee is limited to 112.5% of the costs to the service company of providing 'qualifying services' plus the costs of providing certain non-qualifying services. Costs of running the service company, e.g. audit and secretarial fees, are excluded from the calculation.

(e) If the expenses are not wholly for a qualifying purpose, apportionment must be made.

(f) If a commercially realistic amount is not ascertainable or cannot be reasonably estimated, the whole fee is disallowed: *D32/94*.

Formula to learn

Allowable management fees = Costs of qualifying services × 112.5% + Costs of non-qualifying services

'Qualifying services' means:

(a) non-professional services which provide the infrastructure in which the UB operates, e.g. provision of premises, administrative staff, plant and equipment and office supplies; but

(b) exclude any services rendered by the proprietors or partners of the UB, or any professional (i.e. fee earning) employees of that UB partly involved in the provision of such services.

Costs of any professional employees or salaried partners incurred in the service company can be passed onto the UB by way of a management fee without any mark up. If they belong to a different profession than the proprietors or partners of the UB providing non-fee earning services, e.g. accountant of a medical practice, their services are treated as qualifying services.

By restricting the allowable management fee to 112.5% of the costs to the service company of providing 'qualifying services',

(a) the gross profit of the service company would be limited to 12.5% of the costs of providing the infrastructure of the UB; and

(b) the amount of tax efficient benefits that can be derived by proprietors or partners of the UB would be limited.

It should be noted that notwithstanding the partial denial of a deduction of management fee to the UB, the service company will be fully taxable on the management fee: *D62/01*.

DIPN 24 provides guidance on service company 'Type II' arrangements.

Cases on the application of DIPN 24

The application of DIPN 24 was examined in *D62/01* and *D13/07*, which are discussed in **Appendix 4.**

Example 4

Joy and Laughter ('J&L') operates a dental clinic. It owns a service company, Smiley Services Ltd ('SSL'). SSL employs all the support staff and dentists, leases office premises, provides medical equipment, general clinical support and office supplies. The partners of J&L are the directors of SSL, and they receive a director's fee, rent-free accommodation and various fringe benefits from SSL.

J&L paid SSL a management fee, calculated as 120% of SSL's expenses as follows:

	$
Office rental, rates and management fees	1,500,000
Medical equipment lease	360,000
General clinical support	480,000
Office supplies	340,000
Salaries and fringe benefits of support staff	1,300,000
Salaries and fringe benefits of dentists	4,800,000
Fees and fringe benefits of directors	2,500,000
Operating expenses – audit and secretarial fees	50,000
	11,330,000

The income statement of J&L for the year ended 31 March 2013 is as follows:

	$
Fees	18,000,000
Management fees	(13,596,000)
Other allowable expenses	(1,200,000)
Profit	3,204,000

The income statement of SSL for the year ended 31 March 2013 is as follows:

	$
Management fees	13,596,000
Expenses (see breakdown above)	(11,330,000)
Profit	2,266,000

Tax implications to J&L and SSL:

Pursuant to DIPN 24, the maximum deductible management fees to J&L is 112.5% of the costs of qualifying services, which are the aggregate of the following sums:

	$
Office rental, rates and management fees	1,500,000
Medical equipment lease	360,000
General clinical support	480,000
Office supplies	340,000
Salaries and fringe benefits of support staff	1,300,000
	3,980,000

plus the costs of non-qualifying services, the salaries and fringe benefits of dentists, i.e. $ 9,277,500 ($3,980,000 × 112.5% + $4,800,000).

Cost of the professional employees (the dentists) can be passed onto J&L, but without any mark-up. Cost of the services rendered by partners of J&L (the directors' fees) as well as the operating expenses of the service company are not allowable.

Profits tax payable by J&L = $(3,204,000 + 13,596,000 – 9,277,500) × 15% = $ 1,128,375

Profits tax payable by SSL = $2,266,000 × 16.5% = $ 373,890

It should be noted that although J&L would lose a deduction of $4,318,500 ($13,596,000 – $9,277,500) of the management fees paid to SSL, SSL would still be fully taxable on the management fees (see *D62/01*). As a result of the application of DIPN 24, the combined tax liabilities of J&L and SSL would increase by $712,552 (16.5% of $4,318,500). To avoid this double taxation, J&L should restrict the management fees in accordance with DIPN 24 to 112.5% of SSL's costs of qualifying services and costs of non-qualifying services without any mark up.

Self-test question 4

Mr Young, a famous fashion designer, has been the sole proprietor of Young Design, a fashion designing company in Hong Kong, since 2005. Profits of Young Design have been subject to Hong Kong profits tax. Mr Young is planning to set up a limited company which will act as the Consultant of Young Design. He and his wife will be the only directors and shareholders of the limited company. The Consultant will provide all services and facilities required for the operation and management of the fashion designing business of Young Design and as a reward, will receive a fee equivalent to 90% of Young Design's turnover. Mr Young thinks that he can reduce his business economic risks and save tax by putting this plan into effect.

Required:

Advise Mr Young of the profits tax implications of his plan.

HKICPA March 2000 (Amended)

(The answer is at the end of the chapter)

4.6 Sections 15(1)(m) & 15A – Transfer of right to receive income

Section 15A was enacted in 1987 to counter the possibility that a person could sell the right to receive taxable income (e.g. rental income) to another person for a lump sum which might be treated as a receipt for the sale of a capital asset and so exempt from profits tax, whilst retaining the ownership of the underlying asset that produces the income (e.g. the property from which rental income is derived). The provisions under s.15A supplement the deeming provisions under s.15(1)(m).

Pursuant to s.15A(1), the consideration received (or receivable) by a person in respect of a transfer of a right to receive income from property from that person to another person will be treated as a trading receipt.

Section 15A(1) shall not apply if the person, before or at the time of transfer of the right to receive income from the property to another person, also transfers the ownership or interest in the property to that person.

Example 5

Three years ago, Property Development Ltd ('PDL') incurred a tax loss of $50 million on a property development project. It is now a dormant company. The issued shares in PDL are owned 80% by Property Investment Ltd ('PIL') and 20% by Mr Chan, who is the major shareholder of PIL. PIL owns a block of residential flats in Wanchai from which it derives rental income. It has held those flats for investment purposes for the last ten years. As Mr Chan is thinking of listing the shares in PIL on the Hong Kong Stock Exchange in the next two to three years, he decides that the losses in PDL should be extinguished as soon as possible. Mr Chan is considering the following proposals:

(a) Assigning the rental income derived by PIL to PDL for a period of five years for nil or nominal consideration; or

(b) Assigning the underlying property giving rise to the rental income by PIL to PDL for full market value.

The taxation implications of the above proposals are as follows:

The first proposal

If PIL were to assign the rental income to PDL the assignment could be subject to the provisions of ss.15(1)(m) and 15A. However, as s.15A only applies where valuable consideration is received by the assignor, it appears that the provision would not apply in this case.

Nonetheless, the Commissioner would almost certainly attack the assignment under s.61A as an arrangement entered into for the sole or dominant purpose of obtaining a tax benefit and thus assess PIL as if the assignment had not taken place. The test set out in s.61A is an objective one, i.e. on the basis of various enumerated factors would it be said that the arrangement to transfer income to a loss company was done for the sole or dominant purpose of obtaining a tax benefit. In this case, factors such as the substance of the transaction (it was a gift), and the change in the financial and tax position of both PIL and PDL as a result of the transaction (PIL would be relieved from taxation on the assigned income; and although income would be derived by PDL it would not be subject to tax because it has tax losses available for set-off) indicate that there would be little commercial substance to the transaction and that its dominant purpose is to obtain a tax benefit: see *D20/92*.

The second proposal

If PIL were to assign the underlying property to PDL for valuable consideration, then clearly s.15A could not apply as this provision only affects assignments of income streams which do not involve assigning the ownership of the property producing the income. Moreover, s.61A could not apply as it could not objectively be stated that the transfer was for the sole or dominant purpose of obtaining a tax benefit.

However, two other tax implications must be considered. First, the transfer of the flats would be subject to stamp duty under Head 1(1A). Duty will be levied on the agreement for sale of residential property at the rate of 4.25% on the greater of the consideration provided or market value of the property transferred. PIL and PDL are not associated within the terms of s.45 and therefore no exemption from stamp duty would be available. Second, the possibility of profits tax being levied on any profits on sale derived by PIL cannot be disregarded. Although it is stated that the flats were held for 'investment purposes' it is still very important to consider the nature of the business carried on by PIL in order to determine the viability of this proposal.

It should be noted that although profits would have been received by or accrued to a loss company (PDL), s.61B has no application as both proposals will not involve a change in shareholding in PDL.

In light of the above analysis, Mr Chan would have to consider very carefully whether the second proposal is viable; the first is clearly not viable.

4.7 Sections 16(2), (2A), (2B) & (2C) – Deduction of interest expenses

Restrictions in s.16(2) was introduced in 1986 to counter tax planning arrangements whereby an interest payment was deductible to a taxpayer but the corresponding receipt of interest (which could be derived by the taxpayer or its associate) was non-taxable because the interest was sourced outside Hong Kong, or the recipient of interest is not carrying on business in Hong Kong. Sections 16(2)(c) to (f) restricts the deduction of interest expenses by requiring taxpayers to meet at least one of the four conditions specified therein. Application of s.16(2)(c) to (f) are discussed in **chapter 3, section 8.3** on 'Deductible interest under ss.16(1)(a) and (2)'.

To further combat tax avoidance schemes involving transactions which enable taxpayers to claim interest deductions not otherwise allowable under s.16(2)(c) to (f), s.16(2) was amended with effect from 25 June 2004 to impose additional requirements and restrictions for interest to be deductible. The major amendments are to disallow interest expenses in those cases where the loan is secured by a deposit or another loan made by the borrower or its associate (the secured-loan test in s.16(2A)); or the interest on money borrowed is ultimately paid back to the borrower or its associate (the interest flow-back test in ss.16(2B) and (2C)). Application of these provisions are discussed in **chapter 3, section 8.4** on 'Deductible interest form 25 June 2004 onwards'.

4.8 Sections 16E(8) & 16EA(9) – Commissioner's power to determine the true value of intellectual property rights

Where the Commissioner is of the opinion that the consideration for the purchase or sale of the IPR does not represent its true market value, the Commissioner may determine the true market value of such right. The amount so determined would then be treated as the cost or sale proceeds for the purpose of:

(a) granting the deduction or assessing the sales proceeds in respect of the patent right or right to know-how: s.16E(8).

(b) granting or making the relevant tax deductions or balancing adjustments in respect of the specified IPR: s.16EA(9).

Application of ss.16E(8) and 16EA(9) is discussed in **chapter 3, sections 8.5.6 and 8.5.7** on 'Purchase and sale of IPR'.

4.9 Section 16EC – Deduction under s.16E or 16EA not allowable under certain circumstances

Section 16EA was enacted on 16 December 2011 to grant tax deductions for capital expenditure incurred on the purchase of registered trade marks, copyrights and registered designs, effective from the year of assessment 2011/12. The new law however contains several anti-avoidance provisions which deny tax deductions for patent rights, rights to know-how, trade marks, copyrights and designs (collectively referred to as the **'relevant rights'**) when:

(a) the relevant right is purchased wholly or partly from an associate: s.16EC(2);

(b) the relevant right is transferred under a 'sale and licence back' arrangement: s.16EC(4)(a);

(c) the relevant right is licensed for use wholly or principally outside Hong Kong by a person other than the taxpayer: s.16EC(4)(b);

(d) the whole or predominant part of the purchase consideration is financed directly or indirectly by a non-recourse debt ('leveraged licensing arrangements'): s.16EC(4)(c); and

(e) the specified IPR had been used by the taxpayer before the new law becomes operational, and the taxpayer early terminated a license which would otherwise expire after the new law becomes operational, and then purchases the specified IPR at an unreasonable consideration: s.16EC(1).

It is worth noting that ss.16EC(4)(a), (b) and (c) mirror the controversial s.39E(1)(a) and (b) (discussed in **section 4.18** below). An escape clause to s.16EC(4)(a) is provided in ss.16EC(5) and (6) so that normal business activities will not be affected. Application of these provisions are discussed in **chapter 3, section 8.5.8** on ‘Denial of tax deductions under anti-avoidance provisions in s.16EC’.

4.10 Section 16G(3)(c) – Commissioner’s power to determine the true market value of a prescribed fixed asset on sale

Section 16G(3)(c) empowers the Commissioner to determine the value of a PFA when it is being disposed of at a price other than the true market value in the following circumstances:

(a) the buyer is a person over whom the seller has control; or

(b) the seller is a person over whom the buyer has control; or

(c) both the seller and the buyer are persons over both of whom some other person has control; or

(d) the sale is between a husband and a wife, not being a wife living apart from her husband.

4.11 Section 16J(4) – Commissioner’s power to determine the true market value of environmental protection facilities on sale

Section 16J(4) empowers the Commissioner to determine the value of EPF when it is being disposed of at a price other than the true market value in the following circumstances:

(a) the buyer is a person over whom the seller has control; or

(b) the seller is a person over whom the buyer has control; or

(c) both the seller and the buyer are persons over both of whom some other person has control; or

(d) the sale is between a husband and a wife, not being a wife living apart from her husband.

4.12 Section 18D(2A) – Relevant profit of an old business to be assessed

To combat tax avoidance schemes involving cessation of old (pre-1974) businesses which enable taxpayers’ profits to drop out of assessment in the year of cessation, s.18D(2A) was introduced with effect from 1 April 1979 to add back the drop-out profits as reduced by the drop-out profits of the equivalent period in 1974/75 (i.e. the transitional amount). Application of s.18D(2A) is discussed in **chapter 3, section 11.3** on ‘Basis period – cessation of business’.

4.13 Section 20 – Liability of certain non-resident persons

Pursuant to s.20(2), where a non-resident person carries on business with a resident person with whom he is closely connected and the business is so arranged that it produces to the resident person either no profits or less than the ordinary profits which might be expected to arise in or derive from Hong Kong, the business done by the non-resident person shall be deemed to be carried on in Hong Kong. The non-resident person shall be chargeable to tax in respect of his profits from such business in the name of the resident person as if the resident person were his agent, and all the provision of the IRO shall apply accordingly.

Section 20 applies to the following transactions between a resident and a non-resident:

(a) The resident and the non-resident are closely connected.

(b) There are no profits or less than the ordinary profits for the resident person.

Where s.20 applies, the IRD will deem the non-resident person's business as business carried on in Hong Kong and assess the non-resident person in the name of the resident person as if the resident person were the non-resident's agent. Such treatment is unusual as in most other jurisdictions where transactions have not been carried on at arm's-length, the general treatment is to adjust the pricing between the parties to an arm's length price.

The terms 'resident' and 'non-resident' are not defined in the IRO. Following the common law principles, a company is generally regarded as being resident in the place where it is centrally managed and controlled.

The resident and the non-resident persons will be regarded as **'closely connected'** if:

(a) the Commissioner in his discretion considers that they are substantially identical; or

(b) the ultimate controlling interest of each is owned or deemed under s.20(1)(a) to be owned by the same person or persons.

However, the words **'substantially identical'** are not defined in the IRO.

Pursuant to s.20(1)(b), the ultimate controlling interest of a company refers to the ultimate beneficial ownership of the shares in the company. The controlling interest of a company shall be deemed to be owned by the beneficial owners of its shares, whether held directly or through nominees, and shares in one company held by or on behalf of another company shall be deemed to be held by the shareholders of the last-mentioned company. In this connection, transfer pricing arrangements between associated entities would fall within the ambit of s.20.

There are doubts on the validity of s.20 as taxing the full profit of the non-resident appears to be *ultra vires* where the profits do not have a source in Hong Kong. In practice, profits are likely to be shifted from high tax jurisdictions to Hong Kong rather than out of Hong Kong, and s.20 has seldom been invoked by the IRD, other than in blatant avoidance cases.

Example 6

A Ltd is a trader carrying on business in Hong Kong. Goods are purchased from suppliers in the Mainland at $10 each and sold to customers in Hong Kong at $30 each. Recently, A Ltd is expanding its sales network to Taiwan. For this purpose, a wholly owned subsidiary, B Ltd, is incorporated in Panama. Goods are sold at $12 each to B Ltd, which in turn sells the goods to customers in Taiwan at $30 each.

The mark-up on goods sold in Hong Kong is $20 while the mark-up on goods sold to B Ltd is $2 only. Since A Ltd and B Ltd are closely connected (B Ltd is owned by A Ltd) under s.20(1), s.20(2) will apply if A Ltd is making less profits than might reasonably be expected from the sale of goods to B Ltd.

If B Ltd actively solicits customers, processes orders, bears shipping costs, arranges financing, takes credit risks and inventory risks etc, the lower price of $12 may be justified.

However, if B Ltd does factually nothing other than re-invoicing, the lower price of $12 may be challenged under s.20(2). The business done by B Ltd will then be deemed to be carried on in Hong Kong, and B Ltd will be assessable and chargeable to tax in respect of its profits from such business in the name of A Ltd as if A Ltd were its agent.

4.14 Section 20AE – Assessable profits of non-resident persons regarded as assessable profits of resident persons

To prevent residents taking advantage of the exemption for offshore funds by investing through non-resident entities, with effect from the year of assessment 2006/07,anti-avoidance provisions are introduced as s.20AE. Where s.20AE(1) to (3) applies, a resident person will be deemed to have derived assessable profits in respect of the trading profits earned by the offshore fund from specified transactions and incidental transactions carried out by the offshore fund in Hong Kong; regardless of whether the resident person has received any profit distribution from the offshore fund. Application of s.20AE is discussed in **chapter 4, section 2.8.3** on ‘The deeming provisions (anti-avoidance provisions)’.

4.15 Section 21A – Computation of deemed assessable profits under ss.15(1)(a), (b) or (ba)

To combat tax avoidance schemes involving the sale and lease back of intellectual properties, s.21A provides that the assessable profits of a person’s income deemed taxable under s.15(1)(a), (b) or (ba) shall be taken as 100% (instead of 30%) if the relevant sum is derived from an associate, unless the Commissioner is satisfied that no person carrying on a trade, profession or business in Hong Kong has at any time, wholly or partly, owned the intellectual property. Application of s.21A is discussed in **chapter 3, section 5.1** on ‘Sums specifically chargeable to profits tax’.

4.16 Section 22B – Limited partner loss relief

As a corporate partner in a partnership which incurs an allowable loss can use its share of partnership loss to offset its own company’s profits subject to profits tax, limited partnerships had been widely used in leverage leases to take advantage of the loss relief. To counter these tax avoidance schemes, s.22B(3) was introduced to restrict the loss relief available to a limited partner of a partnership to the lesser of:

(a) the amount of the share of loss from the partnership; and

(b) the relevant sum.

Key terms

‘Limited partner’ is defined in s.22B(1) to mean a person who is a partner in a partnership which is carrying on a trade, profession or business and that person is:

(a) a limited partner in a limited partnership registered under the Limited Partnerships Ordinance;

(b) a general partner in a partnership in which he is not entitled to or does not take part in the management of the partnership but is entitled to have his liabilities, or his liabilities beyond a certain limit, for debts or obligations incurred by the partnership for the purposes of the trade, profession or business, discharged or reimbursed by some other person; or

(c) under the law of any place outside Hong Kong, not entitled to or does not take part in the management of the partnership and is not liable beyond a certain limit for debts or obligations incurred by the partnership for the purposes of the trade, profession or business.

‘Relevant sum’ is defined as the amount of the person’s contribution to the partnership as at the end of the relevant year of assessment in which the loss is sustained, except that where the person ceased to be a partner in the partnership during that year of assessment, it is the time when he so ceased.

Pursuant to s.22B(2), a person's contribution to the partnership at any time is the aggregate of:

(a) the amount which he has contributed to it as capital less the sum of:

  (i) the amounts of capital that he has directly or indirectly drawn out or received back; and

  (ii) anything that he is or may be entitled to at any time while the partnership carries on the trade, profession or business to draw out, receive back or be reimbursed from another person, whether or not the entitlement is enforceable or is pursuant to an unenforceable undertaking or practice; and

(b) the amount of any profits or gains of the partnership to which he is entitled but which he has not received in money or money's worth.

The consequence of applying s.22B is that the amount of loss shared by a limited partner which is available to be used to offset its own company's profits is restricted. Any loss not set off is carried forward in the partnership for set off against future assessable profits of the partnership. They are not available for set off against other income which the limited partner may have in subsequent years.

Formula to learn

Contribution = Contributed capital – Capital withdrawn/paid back – Amount entitled to receive back or be reimbursed + Undistribued profit entitlement

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DIPN 15 (Revised) provides guidance on the application of s.22B.

Example 7

X Ltd and Mr. Y are the partners of Z Co, which commenced a partnership business in Hong Kong in 2012. The partners share profits and losses in the ratio of 4:1 (X Ltd : Mr. Y). X Ltd is a limited partner. X Ltd's capital as at 31 March 2013 was $2 million, and it is agreed that Mr. Y will pay X Ltd $200,000 in 2014.

Both Z Co and X Ltd make up accounts to 30 June. For the year of assessment 2012/13, Z Co has an allowable loss of $15 million while X Ltd has assessable profits of $25 million.

Because X Ltd is a limited partner, s.22B applies to restrict the loss available to X Ltd for set off against its own profits to the lesser of the share of partnership loss and the relevant sum.

Share of loss from Z Co = $15 million × 80% = $12 million

Relevant sum = Contributed capital at 31 March 2013 of $2m – amount reimbursed of $0.2m

= $1.8 million

Loss available for set off is therefore restricted to $1.8 million. X Ltd can claim to set off this loss against its own profits for 2012/13. The balance of share of partnership loss of $10.2 million ($12m – $1.8m) is carried forward in the partnership and set off against X Ltd's share of future assessable profits of the partnership.

4.17 Section 38B – Commissioner's power to determine the true market value of an asset on sale

Section 38B empowers the Commissioner to determine the value of machinery and plant when they are being disposed of at a price other than the true market value in the following circumstances:

(a) the buyer is a person over whom the seller has control; or

(b) the seller is a person over whom the buyer has control; or

(c) both the seller and the buyer are persons over both of whom some other person has control; or

(d) the sale is between a husband and a wife, not being a wife living apart from her husband.

4.18 Section 39E – Depreciation allowances on leased machinery and plant

Section 39E was enacted in 1986 to deny depreciation allowances to the lessor of machinery and plant acquired under a contract entered into after 13 March 1986 in the following circumstances:

(a) the machinery or plant was acquired under a sale and lease back arrangement; or

(b) the machinery or plant, other than a ship or an aircraft, is, while the lease is in force,

  (i) used wholly or principally outside Hong Kong by a person other than the taxpayer; or

  (ii) the whole or a predominant part of the cost of acquisition or construction of the machinery or plant was financed directly or indirectly by a non-recourse debt; or

(c) the machinery or plant is a ship or aircraft or any part thereof and

  (i) the lessee is not an operator of a Hong Kong ship or aircraft; or

  (ii) the whole or a predominant part of the cost of acquisition or construction of the ship or aircraft was financed directly or indirectly by a non-recourse debt.

Key terms in s.2

'Lease' in relation to any machinery or plant includes:

(a) any arrangement under which a right to use it is granted by the owner to another person; and

(b) any arrangement under which a right to use it, being a right derived directly or indirectly from a right referred to in (a) above, is granted by a person to another person;

but excludes a hire-purchase agreement or a conditional sale agreement unless the Commissioner considers that the right under the agreement to purchase or obtain the property in the goods would reasonably be expected not to be exercised.

A lease or any related documentation cannot contain any provision under which the ownership of the goods may pass to the lessee; and an arrangement will not be considered a lease unless the residual value provided for in the lease is reasonable: DIPN 15, para 64 to 66.

A **'hire-purchase agreement'** means an agreement for the bailment (hire) of goods under which the bailee (hirer) may buy the goods or under which the property in the goods will or may pass to the bailee.

A **'conditional sale agreement'** means an agreement for the sale of goods under which the purchase price or part of the purchase price is payable by instalments, and the property in the goods remains in the seller until such conditions as to the payment of instalments or otherwise as may be specified in the agreement are fulfilled.

DIPN 15 (Revised) provides guidance on the application of s.39E.

4.18.1 Sale and lease back arrangement under s.39E(1)(a)

Section 39E(1)(a) applies when

(a) prior to its acquisition by the lessor, the machinery or plant was owned and used by the current lessee, either alone or with others, or any person associated with the lessee (the **'end-user'**); and

(b) the machinery or plant was then leased back to the end-user.

'Owned' is not defined in the IRO and will be given its ordinary meaning. 'Used' is defined to include 'held for use', meaning installed ready for use or held in reserve: s.39E(5).

The lessor will not be entitled to any depreciation allowances under a sale and lease back arrangement except in the following circumstances (s.39E(2)):

(a) the lessor purchases the machinery or plant from the end-user at a price not greater than the price paid to the supplier by the end-user; and

(b) no initial or annual allowances have been awarded to the end-user in respect of that machinery or plant before.

The end-user may submit a notice of disclaimer for his entitlement of the depreciation allowances to the Commissioner within three months of the date on which the machinery or plant was acquired or within such further period as may be permitted by the Commissioner (s.39E(3)).

Example 8 (Adapted from DIPN 15, Example 1)

Company L is a leasing company whereas Company A is a manufacturing company. Both companies are carrying on business in Hong Kong. Under a sale and leaseback arrangement, Company A after revaluing its old machinery sold them to Company L. Company L in turn leased the machinery back to Company A for rental. Before the arrangement, depreciation allowances on the machinery were made to Company A.

Company L would be denied depreciation allowances in respect of the machinery under s.39E(1)(a) because they were owned and used by Company A prior to acquisition. The exception in s.39E(2) did not apply because depreciation allowances were previously granted to Company A.

Example 9 (Adapted from DIPN 15, Example 2)

Company B purchased machinery of $100 million. Before putting them into use and claiming any depreciation allowances, Company B sold to and leased back from Company L the machinery. Under the sale and leaseback arrangement, Company B obtained cash proceeds of $100 million which was the price he paid the supplier and was required to pay a rental of $11 million for a consecutive period of ten years. Assuming each installment contained an effective finance charge of $1 million whereas the market interest should have been $2 million, Company B in effect transferred the depreciation allowances to Company L in return for a lower rate of interest. Company B after receiving the cash of $100 million applied the money for other commercial transactions to produce chargeable profits.

The conditions in s.39E(2) are satisfied. Company L would not be denied depreciation allowances. Company B in effect made use of the sale and leaseback arrangement to obtain cheaper finance for its business use. Company L, the lessor, had in effect committed capital into the machinery, incurring genuine commercial risk. The whole arrangement is a normal commercial transaction.

4.18.2 Leverage lease transaction under ss.39E(1)(b) and (c)

Before s.39E was enacted, the lessor under a leverage lease transaction was able to benefit from the depreciation allowances from machinery or plant without risking their own capital as the whole or a predominant part of the cost of acquisition of the machinery or plant was financed by a non-recourse debt.

'Non-recourse debt' refers to a debt for which the borrower has no absolute liability in respect of the borrowing and in the event of default in the repayment of principal or payment of interest, the rights of the lender are:

(a) limited wholly or predominantly to any or all of the following:

  (i) rights in relation to the machinery or plant or the use of it;

  (ii) rights in relation to goods produced or services provided by the machinery or plant;

  (iii) rights in relation to the loss or disposal of the whole or a part of the machinery or plant (e.g. sale proceeds or insurance recovery);

  (iv) any conjunction of rights under (i), (ii) and (iii) above;

  (v) rights in respect of a mortgage or other security over the machinery or plant;

  (vi) rights related to the financial obligations of the end-user towards the taxpayer in connection with the machinery or plant (e.g. recourse against the lease rentals);

(b) in the opinion of the Commissioner capable of being limited, having regard to either or both of:

  (i) the assets of the taxpayer; and

  (ii) any arrangement to which the taxpayer is a party; or

(c) limited by reason that not all of the assets of the taxpayer (not being assets that are security for a debt of the taxpayer other than a debt arising in relation to the financing of the whole or part of the acquisition cost of the machinery or plant) would be available for the purpose of the discharge of the whole of the debt so arising (including the payment of interest).

Even if rights of the lender are not limited to the asset itself or the income generated by it, the Commissioner will consider the debt a non-recourse debt if the lessor is a limited partnership:

(a) there is no recourse to the limited partner;

(b) the general partner of the partnership has no or few assets, and there is no recourse to the general partner; and

(c) the partnership has no asset apart from the leased asset in question or insufficient asset, and there is no recourse to the partnership.

The IRD has indicated that where a lessor actually contributes or is **fully at risk for at least 51% of the cost of the asset**, they will regard the asset as not being predominantly financed by a non-recourse debt (DIPN 15, para 23 and 78).

Machinery or plant other than ship or aircraft

The lessor of machinery or plant other than ship or aircraft will not be entitled to any depreciation allowances where (s.39E(1)(b)):

(a) the machinery or plant is used 'wholly or principally' outside Hong Kong; or

(b) the whole or a predominant part of the cost of acquisition of the machinery or plant was financed directly or indirectly by a non-recourse debt.

Whether the machinery or plant is used 'wholly or principally' outside Hong Kong is a question of fact to be decided having regard to the circumstances of the case. The IRD has indicated that the following matters are likely to be relevant in determining the issue (DIPN 15, para 17):

(a) the place where the asset is physically located and put to use or held for use;

(b) the nature of the asset;

(c) the nature of the end-user's business;

(d) the locality in which the asset is, under the terms of the lease, designated for use throughout the period of the lease.

Example 10 (Adapted from DIPN 15, Example 3)

Company L is a leasing company carrying on business in Hong Kong. Company C is an enterprise carrying on business in Mainland China. Company L leased its machinery to Company C for rental. The machinery was used by Company C in the Mainland.

Company L would be denied depreciation allowances in respect of the machinery under s.39E(1)(b)(i) because the machinery was used wholly outside Hong Kong. It should be noted that no deduction would be given under s.16G because the machinery under a lease is an 'excluded fixed asset' as defined in s.16G(6) (see also the discussion of *Braitrim (Far East) Limited v CIR* [(2012) CACV 45/2012] in **chapter 3, section 8.5.20** on PFA).

As a practice, the rental income accrued to Company L from leasing the machinery would be regarded as non-taxable.

Ship or aircraft

The lessor of ship or aircraft will not be entitled to any depreciation allowances where (s.39E(1)(c)):

(a) the lessee is not an operator of a Hong Kong ship or aircraft; or

(b) the whole or a predominant part of the cost of acquisition of the ship or aircraft was financed directly or indirectly by a non-recourse debt.

An operator of a HK ship or aircraft is a person who carries on business as an operator of ships or aircraft, being a business controlled and managed in Hong Kong and:

(a) in the case of an aircraft, holds an air operator's certificate issued under the Air Navigation (HK) Order 1995; or

(b) in the case of a ship, is responsible for paying all, or a substantial part of the operating expenses of the ship and the ship operates mainly in the waters of Hong Kong or between the waters of Hong Kong and waters within the Pearl River Delta.

DIPN 15, Part H: Guidelines on lease financing

The IRD has specified a set of guidelines on lease financing (para 68 – 80) as follows:

(a) the lease period should not exceed ten years;

(b) rental rebate to the lessee at termination of the lease is not acceptable;

(c) more than three partners is not acceptable;

(d) any partner's interest in the profits and losses should be at least 30%;

(e) the minimum capital contribution by the lessors themselves is 35% of the cost of the machinery or plant. Interest free and interest bearing loans, even with recourse, will not be accepted;

(f) for recourse debt financing, the lessor must contribute at least 51% of the cost of the machinery or plant throughout the term of the lease.

(g) the transaction should result in assessable profits to the partnership, before the set-off of losses, after the first three-year operation of the lease;

(h) the lessee or ultimate end-user must be a Hong Kong operator of ships or aircraft;

(i) the lease should not involve any advances by the lessee;

(j) any premature termination payments will be treated as assessable profits of the lessor; and

(k) the lessors must demonstrate a profit-making motive (quantum of profit is at least 1% of the cost of machinery), aside from gaining tax benefits, for the transaction.

The IRD has indicated that transactions which do not comply with the specified requirements may lead to the conclusion that the 'sole or dominant' purpose of the transactions is to obtain a tax benefit and s.61A may be invoked accordingly.

Example 11

The management of MEL in Example 2 is also considering another business proposal:

Proposal 2 – To establish a wholly owned subsidiary in Hong Kong with a share capital of $2 million. MEL will sell all its 30 buses to this subsidiary. The subsidiary will further purchase another 10 buses with 60% of the cost financed by a loan from Kam Ngan Finance Ltd. In the proposed loan agreement, the rights of Kam Ngan Finance Ltd will be restricted to the buses and the income from these buses. If MEL is successful in acquiring the shares in THL, THL will lease buses from this proposed subsidiary for its bus services between Hong Kong and Shenzhen. Lease agreements will be made in Hong Kong.

The profits tax implications for the wholly owned subsidiary that would be established if MEL accepts this business proposal:

Normally depreciation allowances will be granted to the owners who use their assets to generate income that is chargeable to profits tax. In this case, after the implementation of the proposals the owner of the new subsidiary would become the owner of the buses. The new subsidiary would be using the buses to generate income through lease income from THL.

However, s.39E provides restrictions related to leased assets and is relevant in this case. Section 39E(1)(a) disallows depreciation allowances to a lessor who has purchased assets from a company and subsequently leased the assets to the same company or its associated company. In this case, all the existing buses are sold by MEL to the new subsidiary which leases the buses to THL, as a subsidiary of MEL. Thus, it is likely that the new subsidiary will not be able to claim depreciation allowances in respect of the costs of acquiring the fleet of 30 buses from MEL. In practice, when the IRD disallows depreciation allowances in respect of leased assets under s.39E, the lease income will not be taxed (DIPN 15, para 17).

Section 39E(1)(b) also may be applicable to the 10 buses to be purchased by the new subsidiary. Section 39E(1)(b) disallows depreciation allowances to a lessor if the assets are used wholly or

principally outside Hong Kong, or the purchase is financed by a non-recourse debt. A non-recourse debt refers to a debt whereby the right of the lender is restricted to the leased asset and the income from the leased asset. In this case the 10 new buses will be purchased with a non-recourse debt. Therefore depreciation allowances would not be claimable.

HKICPA September 2001 (Amended)

5 Penalty on tax avoidance cases

Topic highlights

The IRD takes the view that penalty action for non-compliance is not just confined to evasion cases, but may also apply to tax avoidance cases to which the general anti-avoidance provisions have been successfully applied, provided that the conditions laid down in the relevant penalty provision have been satisfied.

DIPN 15 states that generally speaking, tax evasion attracts heavier penalties than tax avoidance. However, the dividing line between the two is very thin. As a simple practical test to distinguish the two, if a scheme whose possibility of success is entirely dependent upon the IRD never finding out the true facts (i.e. facts have not been disclosed in the return, accounts or any statement submitted to the IRD), it is likely to be a scheme of tax evasion rather than tax avoidance.

On the penalty aspect of tax avoidance cases, the IRD takes the following views:

(a) Whether a certain tax avoidance scheme may be regarded as a tax evasion arrangement and be penalised as such depends on the availability of evidence to prove that the tax avoidance scheme was a sham set up for the purposes of tax evasion. No single factor may conclusively lead to such a conclusion. The wrongdoer would be penalised if there is sufficient admissible evidence to prove that the taxpayer and/or his tax advisor has committed an offence under s.80(2) or s.82(1).

(b) The provisions in ss.61/61A and ss.80(2)/82A(1) are not mutually exclusive. As such, penalty actions can be invoked under s.80(2) or s.82A(1) against the taxpayer concerned regardless of whether s.61 or s.61A has been applied to bring the profits/income in question into the tax net.

In considering whether any penalty action should be invoked, the facts and the circumstances of the particular case will be carefully examined. In general, the IRD will impose penalty on the taxpayers if there were elements of dishonesty or fraudulence involving the use of artificial or fictitious devices, or where the transactions (e.g. expenditure claims) were false or unsubstantiated.

6 Practical considerations in tax planning

Topic highlights

Effective tax planning should be the process of organising the affairs of a taxpayer in a legal and commercially realistic manner so as to reduce or defer the tax liability of the taxpayer.

6.1 Operation review

An 'operation review' is often used before any planning strategy is devised. The following are some of the steps associated with conducting an operation review:

(1) Find out the nature of the business (e.g. trading, manufacturing, service, etc.).

(2) If there is a group of companies, locate an organisational chart to ascertain the relationship between the companies and to identify the role of each of the companies (e.g. investment holding, manufacturing, trading, treasury) within the group.

(3) Identify the operational characteristics of the operations (e.g. flow of goods, services, money and profit with related and unrelated parties).

(4) Identify the areas of operations (national, regional or international).

(5) Analyse the tax legislation, double tax agreements, tax authority's attitude in each of the areas.

(6) Identify any unresolved tax disputes in each jurisdiction and the reasons for the disputes.

(7) Identify the key personnel in each area and their respective authority and responsibility.

(8) Analyse the management decision policy and control system (e.g. centralised or decentralised management, cost centre, profit centre or investment centre).

(9) Analyse the history of the operations, future investment plans and business move.

(10) Analyse the funding of the current operations and foreseeable capital requirements.

(11) Evaluate the operating effectiveness (e.g. profit margin, rate of return on capital) and financial position (e.g. liquidity, matching of funds and investments) of the business.

(12) Identify restrictions on the funding of the business (e.g. thin capitalisation rule).

(13) Evaluate the existing transfer pricing policy and the effective tax rate of the group.

The findings from the operations review should be properly documented, with particular areas highlighted for more in-depth analysis.

6.2 General planning strategies

Tax planning strategies, in general, include:

(a) strategies which look at the overall structure of a business entity, or a group of companies, and seek to identify the most tax-efficient organisation structure and operation structure;

(b) strategies which seek to minimise the tax consequence of a particular transaction or to defer the tax liability arising from that transaction.

Some of the tax planning strategies are very simple (e.g. refund of rent instead of a cash allowance for an employee). Other planning strategies may involve complex and sophisticated mechanisms (e.g. holding companies, trust, etc.). Tax planning strategies must be carefully designed and supported by proper documentation.

The following are examples of tax planning strategies:

(a) increasing the allowable deductions (e.g. use borrowed funds to finance investments that generate chargeable profits, such as machinery and plant and use owners' equity to finance investments that generate non-chargeable profits, such as shares in subsidiaries); and

(b) diverting income to a person who will be levied the least amount of tax in respect of the income (e.g. diverting income to an entity in a low tax jurisdiction or an entity with unutilised tax losses).

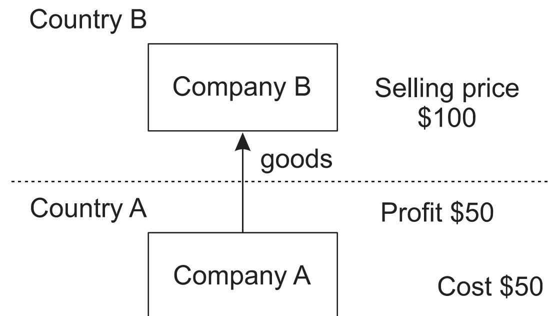
Taxpayers can often discover additional tax planning ideas after carefully studying their respective operations and the provisions in the IRO. For example, sale and leaseback arrangements were once very popular as the lessor and lessee could both benefit from depreciation allowances under the IRO. Such arrangements were deterred after s.39E was enacted in 1986.

6.3 Misconception

It is a misconception that all businesses in Hong Kong wish to reduce their tax payable in Hong Kong. In fact, many businesses try to increase their tax liability in Hong Kong so as to reduce the tax they would otherwise have to pay in some other overseas countries with a higher tax rate.

Example 12

A sale is made by Company A in Country A to Company B in Country B. Profit on the sale ($50) is taxed at, say, 30% in Country A. The tax liability of Company A will be $15.



If the sale is first made by Company A to Company H in Hong Kong at $80 and then by Company H to Company B at $100, the overall tax liability can be reduced to $12.3 ($9 ($30 at 30%) in Country A + $3.3 ($20 at 16.5%) in Hong Kong).

The above example is a typical transfer pricing arrangement. In order to reduce the amount of tax payable in Country A, more Hong Kong tax is paid rather than being avoided.

It should be noted that transfer pricing arrangements are being closely scrutinised by many countries. Rules on arm's length pricing have been established in many jurisdictions. These are outlined in **section 6.5.6** on 'International transfer pricing'.

6.4 Issues of concern in tax planning

There are possible risks and unpredictable consequences associated with tax planning strategies. Tax advisors are obliged to inform their clients of the expected pros and cons of a particular strategy, and to alert their clients to the uncertainties in achieving the intended tax consequences. Tax advisors also need to exercise a duty of care in assisting their clients to implement the planning strategies.

The following are examples of issues of concern in tax planning.

6.4.1 Change of legislation

Even a well-planned strategy cannot guarantee a success. The IRD has taken a more aggressive approach in recent years in scrutinising tax mitigation arrangements or schemes. Anti-avoidance provisions are introduced from time to time to close every possible loophole. An amendment to the legislation with a retrospective effect can eliminate all expected tax benefits from a well-planned strategy.

6.4.2 Professional fees

Fees for formulating tax mitigation strategies are often high. Fees for defending the arrangements before the BOR and courts are even much higher. Possible tax benefits need to be weighed carefully against the costs in formulating the plan, putting it into effect and settling subsequent disputes with the tax authority.

6.4.3 Stop/go dilemma

A tax dispute may take several years to settle. It is difficult for the taxpayer to decide whether to continue the original plan, to change it to another plan or to give up the whole plan and stop before a final decision is obtained from the tax authority.

6.4.4 Holdover/payment of tax

When there is a dispute with the IRD, the Commissioner may grant either a conditional holdover or an unconditional holdover of the tax in dispute.

If a conditional holdover is granted, the taxpayer will need to purchase a Tax Reserve Certificate ('TRC') of the amount in dispute or to provide a banker's undertaking. Deferring payment of tax by lodging an objection is therefore deterred.

If an unconditional holdover is granted, the taxpayer may be able to enjoy a period of tax holiday. However, if there is any tax payable upon the settlement of the dispute, interest will accrue on the amount of tax payable from the original due date to the date of settlement. This amount can be significant as the rate of such interest is to be based on the rate of interest payable on judgment debts, which far exceeds the TRC interest rate. Also, for aggressive tax planning involving non-disclosure of required information, the Commissioner may impose penalties (see *Asia Master Ltd v CIR* [(2006) HCAL 114/2005]).

6.5 Planning for the overall structure of a business enterprise or a group of companies

The following are some of the concerns in planning for the overall structure of a business enterprise or a group of companies:

(a) Selecting a tax haven;

(b) Setting up a holding company;

(c) Setting up a branch or a subsidiary;

(d) Setting up a finance company;

(e) Setting up a management or service company; and

(f) International transfer pricing.

6.5.1 Selecting a tax haven

Potential tax havens were generally categorised as follow:

(a) Countries where there are no relevant taxes (e.g. the Cayman Islands, the Bahamas);

(b) Countries where taxes are imposed on a territorial basis, nil or low rates of tax on income derived from overseas activities (e.g. Panama, Hong Kong); and

(c) Countries where special tax privileges are provided for certain businesses like shipping, finance, banking, insurance, etc. (e.g. Liberia, Isle of Man, Luxembourg, Bermuda).

Depending on the particular needs and objectives of a taxpayer, every place could be a tax haven. A high tax jurisdiction can be a tax haven to certain investors if there are tax incentives such as tax holidays, tax free zones or specific deductions. Other tax havens may have special incentives for certain industries. For example, Liberia and Panama are the tax havens for shipping companies; Guernsey and Bermuda are the tax havens for captive insurance companies.

The following are some of the general criteria in selecting a tax haven for a business enterprise:

(a) Tax treaty network (i.e. treaty shopping);

(b) Exchange control;

(c) Investment incentives;

(d) Legal, political and economic stability;

(e) Tax legislation and rates of tax;

(f) Communication and geographical accessibility;

(g) Banking and accounting services;

(h) Secrecy provisions;

(i) Language;

(j) Costs (including initial set-up cost and recurring maintenance costs); and

(k) Safeguards against expropriation.

The following are some of the well-known low tax jurisdictions (tax havens):

(i) Bermuda

(ii) Cayman Islands

(iii) British Virgin Islands (BVI)

(iv) Bahamas

(v) Channel Islands

(vi) Gibraltar

(vii) Isle of Man

(viii) Cook Islands

(ix) Vanuatu

(x) Labuan

The Organisation for Economic Co-operation and Development ('OECD') has expressed its concern over the 'harmful tax practices' of some so-called tax havens. In April 1998 the OECD issued a report entitled 'Harmful Tax Competition – An Emerging Global Issue'. This report and the work flowing from it have been major contributors to the international debate on a range of taxation matters. The Report and some of the subsequent work of the Forum established by the OECD has focused on looking at offshore financial services and at defining 'tax havens'.

In June 2000, the OECD produced a further report entitled 'Towards Global Tax Co-operation'. This second report set out the progress the OECD felt it had made in identifying and curtailing 'harmful tax practices' both within and outside the OECD. The Report identified 35 jurisdictions as having met the technical criteria for being tax havens.

According to the OECD, the necessary starting point to identify a tax haven is to ask:

> *"Whether a jurisdiction imposes no or only nominal taxes (generally or in special circumstances) and offers itself, or is perceived to offer itself, as a place to be used by non-residents to escape tax in their country of residence".*

Other key factors which can confirm the existence of a tax haven are:

(a) laws or administrative practices which prevent the effective exchange of relevant information with other governments on taxpayers benefiting from the low or no tax jurisdiction;

(b) lack of transparency; and

(c) the absence of a requirement that the activity be substantial, since it would suggest that a jurisdiction may be attempting to attract investment or transactions that are purely tax driven (transactions may be booked there without the requirement of adding value so that there is little real activity, i.e. these jurisdictions are essentially 'booking centres').

The OECD reiterated that each country should retain its sovereign right over national tax matters, i.e. low/no tax rate is not an important criteria in identifying tax havens; rather transparency of a nation's tax system and effectiveness of a nation in exchanging information with other nations are more important and relevant.

The OECD published its blacklist of tax havens in April 2009. The blacklist named and shamed Costa Rica, Malaysia, the Philippines and Uruguay for failing to commit to internationally agreed standard for tax transparency. Subsequently, Costa Rica, Malaysia and Philippines have substantially implemented the internationally agreed tax standard. Uruguay has committed to, but has not yet substantially implemented the internationally agreed tax standard.

Hong Kong and Macau were not mentioned on any of the OECD's lists – not black, not white nor grey. China was mentioned on the final 'white list' of 40 nations cited as gold standards of tax transparency.

In May 2009, the Committee on Fiscal Affairs decided to remove all remaining jurisdictions from the list of unco-operative tax havens in the light of their commitments to implement the OECD standards of transparency and effective exchange of information and the timetable they set for the implementation. As a result, no jurisdiction is currently listed as an unco-operative tax haven.

The OECD published another report summarising the progress made on attacking harmful tax practices as at 18 May 2012 (in respect of the Original Progress Report dated 2 April 2009). Details of the report are summarised as follows:

(a) There are 89 jurisdictions that have substantially implemented the internationally agreed tax standard. The internationally agreed tax standard, which was developed by the OECD with non-OECD countries and which was endorsed by G20 Finance Ministers at their Berlin Meeting in 2004 and by the UN committee of Experts on International Cooperation in Tax Matters at its October 2008 Meeting, requires exchange of information on request on all tax matters for the administration and enforcement of domestic law without regard to a domestic tax interest requirement or bank secrecy for tax purposes. It also provided for extensive safeguards to protect the confidentiality of the information exchanged. China, excluding its two Special Administrative Regions (Hong Kong and Macau), was included in the list. Hong Kong and Macau have committed to implement the internationally agreed tax standard.

(b) There are three jurisdictions that have committed to the internationally agreed tax standard, but have not yet substantially implemented (two tax havens – Niue and Nauru; and one other financial centres – Guatemala).

(c) There is no jurisdiction that has not committed to the internationally agreed tax standard. All jurisdictions surveyed by the Global Forum have now committed to the internationally agreed tax standard.

Visit the website of the OECD at **http://www.oecd.org** for further details.

The residence or nationality of a person is irrelevant in determining a charge under the IRO. Using companies incorporated in a tax haven to carry out activities in Hong Kong cannot reduce the companies' tax liabilities in Hong Kong. However, depending on the situation of the business enterprise, using companies incorporated outside Hong Kong for certain transactions may reduce the enterprise's exposure to tax.

6.5.2 Setting up a holding company

Setting up an offshore holding company may enable an entity to:

(a) protect the group's overseas assets against expropriation;

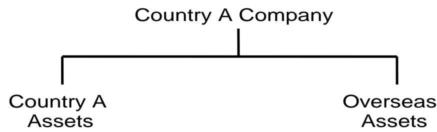
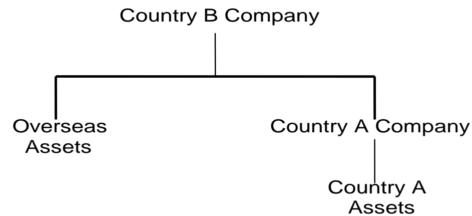
(b) reduce exposure to capital gains tax or stamp duty on transfer of equity interest or assets; and

(c) reduce withholding tax on dividends by treaty shopping.

Protecting the group's overseas assets against expropriation

It would be undesirable for an investment holding company to be incorporated in a jurisdiction with political and economic instability as well as high risk of asset expropriation (see **Scenario 1** below).

One way to avoid the above situation would be to carefully select a jurisdiction (e.g. with political and economic stability) wherein the risk of asset expropriation is low to incorporate the holding company (see **Scenario 2** below).

Scenario 1	Scenario 2
Investment holding company set up in Country A (a country with political and economic instability) to hold the assets in Country A and overseas assets (less favourable situation).	Investment holding company set up in Country B (a country with political and economic stability) to hold the shares in a Country A Company as well as overseas assets. Country A Company only holds assets in Country A.
	

Reducing exposure to capital gains tax or stamp duty on transfer of equity interest or assets

When transferring/disposing of interest in a subsidiary and/or assets in a subsidiary, the following are the relevant tax considerations:

(i) withholding tax;

(ii) capital gains tax;

(iii) profits tax; and

(iv) stamp duty.

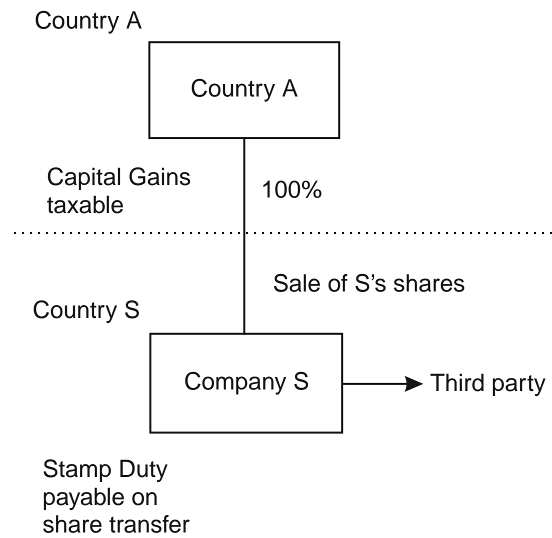
A tax planning strategy is to reduce or minimise the above.

Example 13

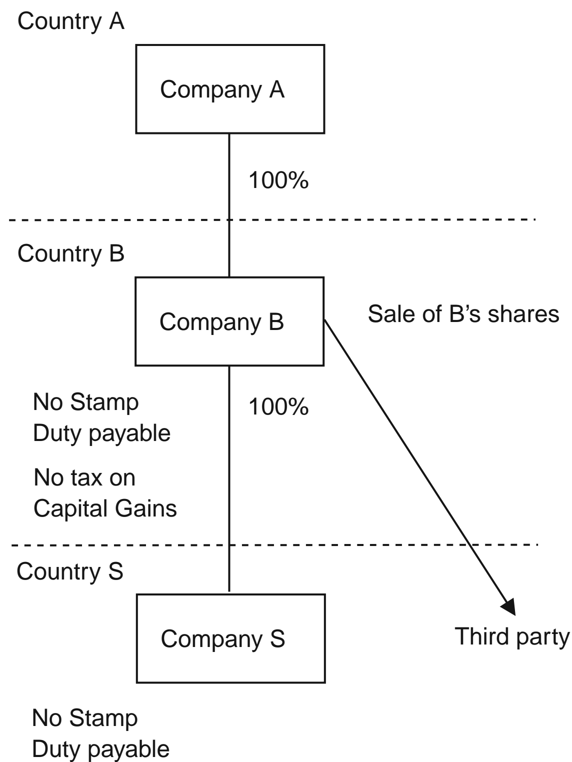
Share transfers in Country S are subject to stamp duty and there is capital gains tax in Country A. If a company in Country A disposes of its subsidiary in Country S at a profit, the profit will be subject to capital gains tax in Country A and the transfer of the subsidiary's shares to another party will also be subject to stamp duty in Country S (refer to **Scenario 1**).

On the other hand, if an intermediary holding company (or a two-tier intermediary holding structure) is formed in a tax haven to hold the shares in the subsidiary in Country S, the tax exposure could be reduced if the tax haven jurisdiction does not impose stamp duty or capital gains tax on the transfer of shares in companies incorporated/resident in that jurisdiction (refer to **Scenario 2 and Scenario 3** where the intermediary holding company(s) was incorporated in a tax jurisdiction with no stamp duty imposed on share transfer nor capital gains tax on the profits derived from the disposal of investment).

Scenario 1 – No intermediary holding company



Scenario 2 – With an intermediary holding company in Country B, a tax haven



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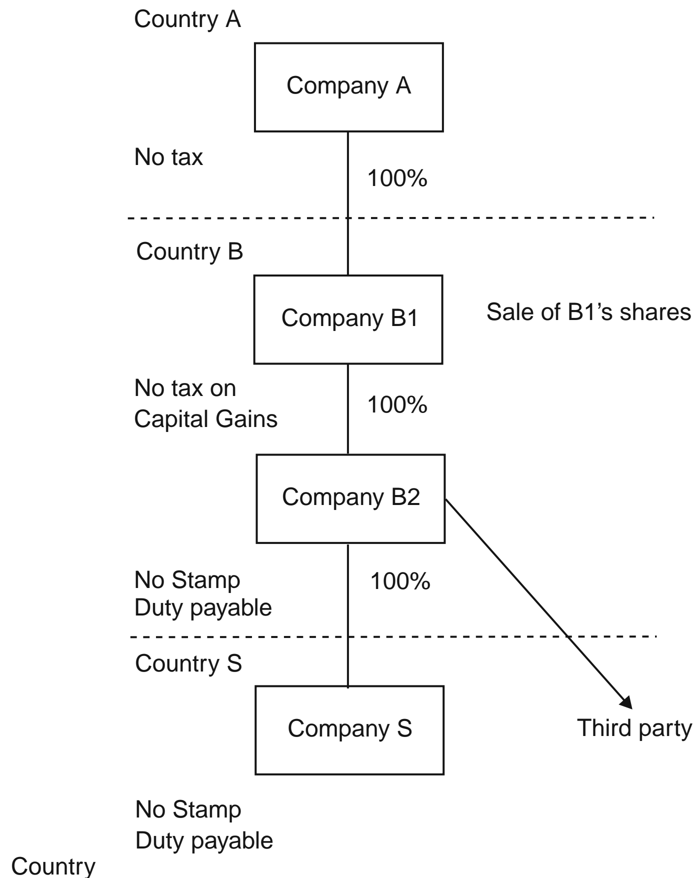
Scenario 3 – With a two tier intermediary holding company in Country B, a tax haven



Before a proper group structure is decided, it is important to consider the withholding tax issues and also the tax treaties between the countries where the companies within the group reside.

Reducing withholding tax on dividends by treaty shopping

A holding company may be set up in a jurisdiction which imposes no tax on dividends (e.g. Hong Kong) or a country which has entered into double tax arrangements with other jurisdictions so that dividends paid out from those jurisdictions will only be subject to a minimum rate of withholding tax. The same principle applies to income like interest or royalties.

Hong Kong imposes no tax on dividend income. The disadvantage of setting up a holding company in Hong Kong is that Hong Kong does not have many DTAs with other countries to reduce the withholding tax on dividends or interest paid out from the subsidiaries established in such jurisdictions. An illustration is as follows:

Scenario 1	Scenario 2
Holding company in Hong Kong, subsidiary in Country B. Withholding tax on dividends in Country B is 20%. There is no DTA between Hong Kong and Country B.	Holding company in Country A, subsidiary in Country B. Country A imposes a tax on dividend income at 10%. Withholding tax on dividends in Country B is 20%. However, there is a DTA with Country A and withholding tax is reduced to 10%.

Scenario 1	Scenario 2
Subsidiary in Country B declares $1,000 as dividends. $800 ($1,000 × (1 - 20%)) will be paid to the holding company in Hong Kong.	Subsidiary in Country B declares $1,000 as dividends. $900 ($1,000 × (1 - 10%)) will be paid to the holding company in Country A.
There is no tax on dividends in Hong Kong. $800 will be available for distribution to the ultimate shareholders.	Country A imposes a tax on dividend income at 10%. $810 (i.e. $900 × (1 – 10%)) will be available for distribution to the ultimate shareholders.

From the above illustration, setting up a holding company in Country A is more beneficial to the ultimate shareholders.

6.5.3 Setting up a branch or a subsidiary

In many countries, setting up a branch is much easier than incorporating a subsidiary. For example, many countries impose capital requirements on certain industries such as banks or insurance companies. It would be difficult to form a subsidiary by injecting the required capital and branches are often set up in these countries instead.

Setting up a branch in Hong Kong is less formal than incorporating a subsidiary. Besides, setting up a branch will not involve any capital duty or stamp duty.

However, setting up a branch has the following disadvantages:

(a) A branch, not being a separate legal entity, has no limited liability and the head office will therefore bear the risk of taking up the liabilities of the branch should there be a failure in its business.

(b) It will be difficult to apply transfer pricing arrangements with a branch although a reasonable share of the head office administrative expenses is likely to be allowed by the tax authority.

(c) No tax deferral can be obtained by the head office if a branch makes a profit but delays the repatriation.

On the other hand, a subsidiary is a separate legal entity. Setting up a subsidiary to carry on a high risk business can limit the maximum loss to the capital invested. It is not uncommon for each of the companies of a shipping group to own and operate one ship only. If one ship crashed, the company holding that ship may be liquidated and all the other companies within the same group will not be affected. It may also be easier to apply transfer pricing arrangements with a subsidiary as both parties are separate legal entity. A subsidiary may delay the declaration of dividends to its holding company. The holding company will then be able to defer the tax on dividend income to a later period.

A branch is within the definition of 'PE' under IRR 5. If a business is carried on by the branch set up by an overseas company in Hong Kong and there is profit arising in or derived from Hong Kong, the company will be chargeable to tax in Hong Kong.

There is no difference in the tax imposed on a branch or a subsidiary carrying on business in Hong Kong. If the branch keeps proper accounts that show the true profits derived from Hong Kong, profits tax will be computed based on those accounts (IRR 5(2)(a)).

If the branch (other than a branch of a bank) does not keep any accounts or its accounts do not reflect the true profits derived from Hong Kong, the assessable profits may be computed based on the following formula (IRR 5(2)(b)):

Formula to learn

$$\text{Worldwide profits as adjusted for tax purposes} \times \frac{\text{Hong Kong turnover}}{\text{Worldwide turnover}}$$

If an assessor considers that it would be impractical or inequitable to adopt the above formula, he may compute the amount of assessable profits on a fair percentage of the branch's turnover in Hong Kong (IRR 5(2)(d)).

For tax filing purposes, a branch in Hong Kong will need to submit:

(a) profits tax return of the branch;

(b) management accounts of the branch certified by a director or a manager; and

(c) audited accounts of the company (head office and branch) if the country of incorporation of the company requires an annual statutory audit.

For tax filing purposes, a subsidiary in Hong Kong will need to submit:

(a) profits tax return for itself; and

(b) audited accounts of itself.

6.5.4 Setting up a finance company

Many countries have a thin capitalisation rule to prohibit heavy borrowing. For example, a company with issued capital of $10,000 in a country may only be allowed to borrow $10,000 (100% of its issued capital). Other countries may have exchange control on borrowing and lending in foreign currencies.

By setting up an offshore finance company, the company may be able to:

(a) avoid the restrictions of the thin capitalisation rule;

(b) circumvent foreign exchange control;

(c) control the bad debt risk and foreign exchange risk; and

(d) reduce withholding tax on interest by treaty shopping.

There is no thin capitalisation rule or foreign exchange control in Hong Kong. Offshore interest earned by a Hong Kong company (other than a FI) is not taxable in Hong Kong. However, Hong Kong does not have many DTAs with other countries to reduce the withholding tax on interest paid out from overseas jurisdictions.

6.5.5 Setting up a management or service company

Management companies are often set up to centralise the management of the companies within a group for the purpose of cost effectiveness.

Example 14

All companies within a group need accounting and secretarial services. A management company can be set up to provide the necessary services to the group companies in return for a fee.

The fee can be based on the actual expenses incurred in providing the services (with or without a mark-up), or sometimes it can be based on the payer's ability to pay. In the latter case, the arrangement may be able to avoid a loss being suffered by a newly established company within the group so as to reduce the overall tax burden of the group (if there is no group loss relief available).

The overall tax burden can also be reduced if fees are paid out of high tax jurisdictions to a management company established in a low tax jurisdiction. However, the transfer pricing policy may not be accepted by the tax authority of the high tax jurisdiction and rules on arm's length

pricing have been established in many jurisdictions which are outlined in **section 6.5.6** on 'International transfer pricing' below.

Since the tax system in Hong Kong is largely based on a territorial basis and the source of the service income is determined by the operations test, it is possible to obtain a tax benefit by setting up a service company in Hong Kong.

Example 15

A service company is set up in Hong Kong to provide marketing services to a company in Country A. If the marketing services are performed outside Hong Kong, say, in Europe, a double benefit may be obtained, as the company in Country A will be able to deduct the service fees while the recipient in Hong Kong is not taxable on the service fees which are offshore. It is important to structure the arrangement so as to ensure that the payer company will not infringe any of the anti-avoidance provisions in its home country and is able to claim the deduction; and that the payee company is not chargeable to tax in the place(s) where it renders its services. It is also important to keep sufficient documentary evidence to substantiate the offshore claims of the payee company in Hong Kong.

In practice, it is difficult for a management company established in Hong Kong to claim its management fee income as offshore because management is generally regarded as a continuous process likely to be performed at the place where the recipient company is managed and controlled.

6.5.6 International transfer pricing

Transfer pricing is broadly used to describe cross-border transactions between related parties (such as companies within a multinational enterprise). The nature of transactions includes the following:

(a) sale, purchase, assignment and use of tangible property, including the business of selling, purchasing, assigning and leasing tangible property such as buildings, other structures, means of transportation, machinery, tools and merchandise;

(b) assignment and use of intangible property, including the business of assigning ownership of, or providing the right to use, proprietary rights such as patents, designs, trade marks, copyright materials or secret processes or formulas or other properties of a similar nature;

(c) financing, including the business of all types of long and short term loans, sale and purchase of negotiable instruments, and all kinds of interest bearing advances; and

(d) provision of services, including the provision of services such as administration, marketing, management, technical support, consultancy, agency, research and development, legal and accounting, etc.

If the goods, services or royalties for intangibles are underpriced, the profitability of the seller and payer of service fees and royalties is reduced while that of the buyer and the recipient is increased. On the contrary, if the transactions are overpriced, the profitability of the seller will increase while that of the buyer will decrease. Before considering the tax impact, it is worth noting that profitability of the group as a whole is the same, only the profit of the individual companies within the group is affected by the transfer pricing policy.

Where the companies within a group are situated in different countries with different tax systems, the before tax profit of the group as a whole will remain the same while the after-tax profit of the group as a whole will be affected by the transfer pricing policy.

Although transfer pricing can be used as a method to reduce the tax burden of a global enterprise, the transfer pricing policy within a group is often not merely a tax concern. For example, a particular transfer pricing policy may be used to keep the market share of a product in a particular

market or to circumvent foreign exchange control. The aim to minimise the global tax cost of the group may only be subsidiary.

As indicated above, it is more often the case that profits are booked in Hong Kong which are greater than what would otherwise arise under an arm's length transaction. Unless an offshore claim has been successfully lodged with the IRD, the IRD will certainly tax the profit booked in Hong Kong without being concerned with the application of transfer pricing provisions in other jurisdictions.

Major transfer pricing methods adopted in other jurisdictions include:

(a) comparable uncontrollable price (CUP);

(b) resale price;

(c) cost-plus; and

(d) others.

Some of the tax authorities have established rules of priority in adopting the above methods. The IRD has stated in DIPN 46 that it will also follow OECD's transfer pricing guidelines. See DIPN 46, para 66 to 70, for a detailed discussion of the methodologies and issues relating to transfer pricing adjustments.

(a) **Comparable Uncontrollable Price (CUP) Method**

The comparable uncontrollable (or unrelated) price method looks to the price charged on comparable transactions between unrelated parties.

There are two forms of comparison, internal and external.

Internal comparison	External comparison
Internal comparison compares the inter-company price with that charged or paid by the company in transactions with unrelated parties.	External comparison compares the prices charged and paid by unrelated parties for a similar product.
Company A Sales / CUP / Sales Subsidiary / Unrelated distributor	Company A / Company B Sales / CUP / Sales Subsidiary / Unrelated distributor

Transactions will not be comparable when there is no external market for the goods and services or the goods and services are not offered for sale to third parties. Such situations are common with semi-finished goods or technology transfers.

Example 16 (Adapted from DIPN 46, Example A1)

Co HK, resident in Hong Kong, manufactures a precision cutting machine which it sells at a price of $1 million to a Belgian subsidiary but at a price of $1.2 million to an independent Belgian enterprise.

Application of the internal CUP method directly and reliably reflects the arm's length price. Assuming all other factors of comparability such as contractual terms are the same, an amount of $0.2 million should be added to Co HK's assessable profits.

Example 17 (Adapted from DIPN 46, Example A2)

Co HK, resident in Hong Kong, is trading in listed securities and holds stock which would raise $20 million on the Hong Kong Stock Exchange. It sells to an overseas associated enterprise the stock for $10 million.

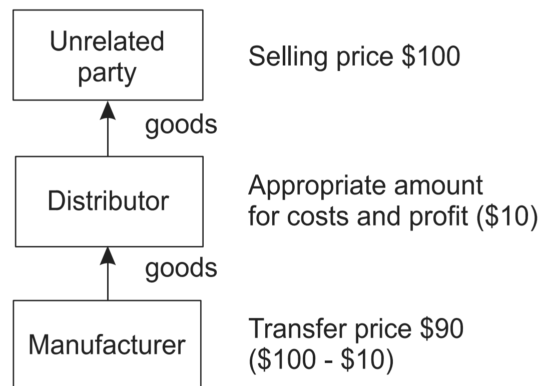
Application of the external CUP method is appropriate because it reliably reflects the arm's length price. A sum of $10 million should be added to Co HK's assessable profits.

(b) **Resale price method**

The resale price method begins with the price at which a product purchased from a related person is resold to an unrelated purchaser. The price is then reduced by an 'appropriate' margin. Such margin would be sufficient for the reseller to recover his costs and make a profit.

Example 18

A distributor purchases goods from a related manufacturer. The goods can be sold to an unrelated person at $100. $10 is considered to be the appropriate amount for the distributor to recover its costs and make a profit. The selling price of the goods from the manufacturer to the distributor can then be set at $90.



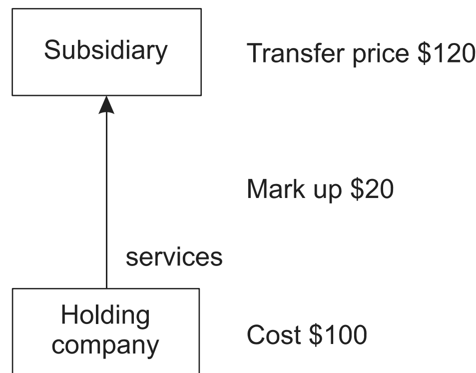
The obvious difficulty with this method is the determination of the amount of the appropriate margin. This method is difficult to apply when the distributor adds some value to the product or the product is resold to an unrelated party after a long period of time.

(c) **Cost plus method**

The cost plus method requires the supplier to add an appropriate mark-up to the costs.

Example 19

A holding company has incurred $100 to arrange for certain services for the subsidiary. By adding $20 (i.e. a 20% mark-up) to the costs, $120 will be charged to the subsidiary for services provided.



This method suffers from the problem of determining the cost base and also the appropriate mark-up.

On a cross-border basis, determining the cost base is difficult as accounting policies differ from country to country. Another weakness of this method is that it assumes the supplier always makes a profit.

This method is often used in the following situations:

(i) Sale of semi-finished goods between related parties;

(ii) Share of facilities between related parties;

(iii) A specialised product is produced for one customer and the costs of production are hardly predictable (e.g. construction of a military facility).

(d) **Other methods**

Examples of other methods include:

(i) comparable profit (to compare a company's overall profits with that of a similar business enterprise);

(ii) net yield method (to compute an appropriate yield on the investment in the enterprise);

(iii) return on assets; and

(iv) return on equity.

Though some overseas companies would like to shift profits to Hong Kong, some Hong Kong companies have set up tax haven companies and shift profits to these companies (see *Asia Master Ltd v CIR* (2006) and *Ngai Lik Electronics Co Ltd v CIR* (2009)). The concept of transfer pricing is important for international tax planning.

In general, the transactions between companies of a multinational group include:

(a) sale and purchase of goods;

(b) technology transfers (e.g. patent, trade mark, secret process);

(c) provision of services (e.g. marketing, management); and

(d) financing transactions (e.g. loans, leases).

The following examples illustrate the concept of transfer pricing policy for tax planning.

Example 20: Transfer pricing in sale and purchase of goods

The following is an example of a transfer pricing arrangement in the sale and purchase of goods. Other expenses such as exchange differences are ignored for illustration purpose.

Background information

There are three group companies (Company A, Company B and Company C) in three countries (Country A, Country B and Country C).

Country A	Country B	Country C
Tax rate 50%	Tax rate 40%	Tax rate 20%
Company A (manufacturing company)	Company B (trading company)	Company C (trading company)

Scenario 1 – No transfer pricing arrangement		
Company A	**Company B**	**Company C**
Produce product A at a cost of $100 Sell product A to customers in Country B at $150 Marketing expenses $10	No related party transaction	No related party transaction
Taxable profit $40 (150 –100 – 10)	N/A	N/A
Tax $20 ($40 \times 50\%$)	N/A	N/A
Total taxable profit = $40		
Total tax = $20		

Scenario 2 – With transfer pricing arrangement between two companies		
Company A	**Company B**	**Company C**
Produce product A at a cost of $100 Sell product A to Company B at $120	Buy product A from Company A at $120 Sell product A at $150 Marketing expenses $10	No related party transaction
Taxable profit $20 (120 –100)	Taxable profit $20 (150 –120 – 10)	N/A
Tax $10 ($20 \times 50\%$)	Tax $8 ($20 \times 40\%$)	N/A
Total taxable profit = $40 (20 + 20)		
Total tax = $18 (10 + 8)		

Scenario 3 – With transfer pricing arrangement between 3 companies		
Company A	**Company B**	**Company C**
Produce product A at a cost of $100 Sell product A to Company C at $110	Buy product A from Company C at $130 Sell product A at $150 Marketing expenses $10	Buy product A from Company A at $110 Sell product A to Company B at $130
Taxable profit $10 (110 – 100)	Taxable profit $10 (150 – 130 – 10)	Taxable profit $20 (130 – 110)
Tax $5 (10 × 50%)	Tax $4 (10 × 40%)	Tax $4 (20 × 20%)
Total taxable profit = $40 (10 + 10 + 20)		
Total tax = $13 (5 + 4 + 4)		

In devising a transfer pricing policy for purchase and sale of goods, the transfer pricing rules in the relevant countries have to be considered. In general, most jurisdictions adopt the arm's length transfer pricing rule.

In Hong Kong, s.20 does not specify the use of the arm's length concept and the Commissioner rarely applies s.20. In *CIR v Tai Hing Cotton Mill (Development) Ltd* (2008), the CFA considered that the transaction between the taxpayer's holding company and the taxpayer was not at arm's length and held that the Commissioner was entitled under s.61A to substitute the formula set by the related companies for the purchase price of the property concerned by the market value. The arm's length principle is therefore important and the commercial obligations and functional roles of all the parties in a transaction should be carefully considered. In *Asia Master Ltd v CIR* (2006), the judge opined that a transfer pricing report should include an analysis of assets, risks and functions of the parties involved.

Example 21: Transfer pricing in technology transfers

The following is an example of a transfer pricing arrangement in technology transfers.

Background information

There are two group companies (Company A and Company B) in two countries (Country A and Country B). A patent is to be acquired from a third party for use by Company A.

Country A	Country B
Tax rate 40%	Tax rate 20%
No deduction for patent rights	Specific deduction for patent rights: 100% in year of purchase
Company A (manufacturing company)	Company B (manufacturing company)
Taxable profit $100	Taxable profit $100

Scenario 1 - No inter-company licensing	
Company A	**Company B**
Purchase a patent at $100	N/A
Taxable profit $100	Taxable profit $100
Tax $40 (100 × 40%)	Tax $20 (100 × 20%)
Total taxable profit = $200 (100 + 100)	
Total tax = $60 (40 + 20)	

Scenario 2 – With inter-company licensing	
Company A	**Company B**
Pay a license fee of $10 to Company B for the use of the patent right	Purchase the patent at $100 and license it to Company A at an annual fee of $10
Taxable profit $90 (100 – 10)	Taxable profit $10 (100 – 100 + 10) in the year the patent was purchased Taxable profit $110 (100 + 10) in subsequent years
Tax $36 (90 × 40%)	Tax $2 (10 × 20%) in the year the patent was purchased Tax $22 (110 × 20%) in subsequent years
Total taxable profit = $100 (90 + 10) in the year the patent was purchased = $200 (90 + 110) in subsequent years	
Total tax = $38 (36 + 2) in the year the patent was purchased = $58 (36 + 22) in subsequent years	

Example 22: Transfer pricing in provision of services

The following is an example of a transfer pricing arrangement in provision of services.

Background information

There are three group companies in three countries. Services are provided by the holding company to its subsidiaries at a fee.

Country A	Country B	Country C
Tax rate 50%	Tax rate 40%	Tax rate 20%
Company A (holding company)	Company B (subsidiary)	Company C (subsidiary)

Scenario 1 – Service fee based on usage of services		
Company A	**Company B**	**Company C**
Profit $200 (before cost of management services and management fee income)	Profit $200 (before management fee charges)	Profit $200 (before management fee charges)
Cost of management services $100	N/A	N/A
Use of services 50%	Use of services 30%	Use of services 20%
Management fee income from Company B $30 Management fee income from Company C $20	Management fee paid to Company A $30	Management fee paid to Company A $20
Taxable profit $150 (200 – 100 + 30 + 20)	Taxable profit $170 (200 – 30)	Taxable profit $180 (200 – 20)
Tax $75 (150 × 50%)	Tax $68 (170 × 40%)	Tax $36 (180 × 20%)
Total taxable profit = $500 (150 + 170 + 180)		
Total tax = $179 (75 + 68 + 36)		

Scenario 2 – Service fee not based on usage of services		
Company A	**Company B**	**Company C**
Profit $200 (before cost of management services and management fee income)	Profit $200 (before management fee charges)	Profit $200 (before management fee charges)
Cost of management services $100	N/A	N/A
Use of services 50%	Use of services 30%	Use of services 20%
Management fee income from Company B $40 Management fee income from Company C $10	Management fee paid to Company A $40	Management fee paid to Company A $10
Taxable profit $150 (200 – 100 + 40 + 10)	Taxable profit $160 (200 – 40)	Taxable profit $190 (200 – 10)
Tax $75 (150 × 50%)	Tax $64 (160 × 40%)	Tax $38 (190 × 20%)
Total taxable profit = $500 (150 + 160 + 190)		
Total tax = $177 (75 + 64 + 38)		

Example 23: Transfer pricing in borrowing and lending

The following is an example of a transfer pricing arrangement in borrowing and lending.

Background information

There are two group companies in two countries. One of the companies is in need of funds.

Country A	Country B
Tax rate 40%	Tax rate 20%
Company A (trading company)	Company B (finance company)
Taxable profit $100	Taxable profit $100

Scenario 1 - No inter-company borrowing	
Company A	**Company B**
Borrow $100 at 10% per annum	N/A
Taxable profit $90 (100 - 10)	Taxable profit $100
Tax $36 (90 × 40%)	Tax $20 (100 × 20%)
Total taxable profit = $190 (90 + 100)	
Total tax = $56 (36 + 20)	

Scenario 2 – With inter-company borrowing	
Company A	**Company B**
Borrow $100 from Company B at 12% per annum	Borrow $100 at 10% per annum Lend $100 to Company A at 12% per annum
Taxable profit $88 (100 – 12)	Taxable profit $102 (100 – 10 + 12)
Tax $35.2 (88 × 40%)	Tax $20.4 (102 × 20%)
Total taxable profit = $190 (88 + 102)	
Total tax = $55.6 (35.2 + 20.4)	

The tax rules on deemed interest, tax deductibility of interest expenses, thin capitalisation rule, general anti-avoidance provisions and withholding tax implications on interest income have to be considered in cross-border inter-company borrowing.

Example 24: Transfer pricing in leasing

The following is an example of a transfer pricing arrangement in leasing.

Background information

There are two group companies (Company A and Company B) in two countries (Country A and Country B). A machine is acquired from a third party for the use of Company A.

Country A	Country B
Tax rate 40%	Tax rate 20%
Depreciation allowances: 20% on cost for five years	Depreciation allowances: 100% in the year of purchase
Company A (manufacturing company)	Company B (finance company)
Taxable profit $100	Taxable profit $100

Scenario 1 - No lease arrangement					
Company A			**Company B**		
Purchase a machine at $100 for use in business			N/A		
Year	*Taxable profit*	*Tax at 40%*	*Year*	*Taxable profit*	*Tax at 20%*
	$	$		$	$
1	80	32	1	100	20
2	80	32	2	100	20
3	80	32	3	100	20
4	80	32	4	100	20
5	80	32	5	100	20
Total	400	160	Total	500	100
Total taxable profit = $900 (400 + 500)					
Total tax = $260 (160 + 100)					

Note: Taxable profit of Company A = profit $100 - depreciation allowances $20 = $80

Scenario 2 – With a lease arrangement					
Company A			**Company B**		
Lease the machine from Company B at an annual charge of $30			Purchase the machine at $100 Lease the machine to Company A at an annual charge of $30		
Year	*Taxable profit*	*Tax at 40%*	*Year*	*Taxable profit*	*Tax at 20%*
	$	$		$	$
1	70	28	1	30	6
2	70	28	2	130	26
3	70	28	3	130	26
4	70	28	4	130	26
5	70	28	5	130	26
Total	350	140	Total	550	110
Total taxable profit = $900 (350 + 550)					
Total tax = $250 (140 + 110)					
Total tax in year 1 would reduce from $52 (32 + 20) to $34 (28 + 6).					

Notes:

Taxable profit of Company A = profit $100 – lease payment $30 = $70

Taxable profit of Company B in year 1 = profit $100 – depreciation allowances $100 + lease payment $30 = $30

Taxable profit of Company B in subsequent years = profit $100 + lease payment $30 = $130

Example 25

B Ltd is an electronics manufacturer in Taiwan. At the relevant times, there was a restriction imposed on Taiwan enterprises whereby they could not deal with their counterparts in the Mainland directly. In order to circumvent such trade barriers, B Ltd established a wholly-owned subsidiary, C Ltd, in Hong Kong, and through C Ltd subcontracted part of the manufacturing process to a factory in the Mainland ('the Mainland Factory') by way of import processing. The Mainland Factory is a foreign investment enterprise in which 60% of the shares were held by C Ltd. All along B Ltd was the only customer of C Ltd. It supplied, through C Ltd, all the required raw materials and technology to the Mainland Factory. For the sake of quality assurance, B Ltd also seconded a number of engineers from Taiwan to the Mainland to supervise the manufacturing process undertaken by the Mainland Factory.

In Hong Kong, C Ltd neither had any staff nor a permanent office. It engaged a secretarial company to handle various tasks such as receipt and issue of invoices, transhipment of raw materials and semi-finished parts, customs declaration and account settlement on its behalf and under its instructions. It resold the parts to B Ltd at a mark-up of 2%, which resulted in minimal profits to C Ltd after deducting the service fees paid to the secretarial company.

C Ltd claimed that all of its profits were derived offshore as the semi-finished parts were produced in the Mainland, and it did not have any office nor staff in Hong Kong. The offshore claim is now being reviewed by the assessor. Further, the assessor also queries whether the mark-up charged on B Ltd satisfied the arm's length principle.

Required:

Assuming that you are appointed as the tax representative of C Ltd,

(a) Evaluate the offshore claim lodged by C Ltd (the evaluation should cover both the arguments for and against the offshore claim); and

(b) Discuss how you should address the arm's length issue raised by the assessor and the transfer pricing methodologies that you may adopt in this connection.

Solution

(a) **Evaluation of the offshore claim**

Section 14 provides, *inter alia*, that profits tax shall be charged on every person carrying on a trade, profession or business in Hong Kong in respect of its profits arising in or derived from Hong Kong.

C Ltd was incorporated in Hong Kong and engaged a secretarial company to perform certain business activities on its behalf in Hong Kong. Therefore, it was carrying on business in Hong Kong and its profits should be chargeable to profits tax if they were sourced in Hong Kong.

As laid down by Lord Bridge in *CIR v Hang Seng Bank Ltd* [(1991) 1 AC 306] and expanded by Lord Jauncey in *CIR v HK-TVB International Ltd* [(1992) 2 AC 397], the broad guiding principle for determining the source of profits was *"one looks to see what the taxpayer has done to earn the profit in question and where he has done it"*.

Having regard to the facts given in the question, there are two possible analyses on the question of source:

Analysis (1): Service income

The profits which C Ltd derived were in the nature of service income and it should have a source in Hong Kong because of the following:

(1) There is no evidence that C Ltd did anything outside Hong Kong. All the offshore activities were undertaken by B Ltd and the Mainland Factory. On the authority of *ING Baring Securities (Hong Kong) Limited v CIR* [(2008) 1 HKLRD 412], the source of the profits for
C Ltd must be ascribed to its own operations, not to those of B Ltd and the Mainland Factory. In any event, the available facts seem to suggest that the three companies dealt with each other on their own account. There is no evidence that B Ltd and the Mainland Factory acted on behalf of C Ltd.

(2) C Ltd arranged the production of electronic parts for B Ltd, and it was such service which earned C Ltd its profits. As C Ltd did all the arrangements, such as transhipment, invoicing, customs clearance, etc., in Hong Kong, the source of its profits should be in Hong Kong.

(3) The purpose of establishing C Ltd was to circumvent the then trade barrier between Taiwan and the Mainland. C Ltd was remunerated for its interposition in the business relationship between B Ltd and the Mainland Factory and for the necessary work in Hong Kong which it performed to make this interposition effective. On the authority of *Kim Eng Securities (Hong Kong) Ltd v CIR* [(2007) 2 HKLRD 117]), no matter how little C Ltd did in Hong Kong, if the profits were derived from what it did in Hong Kong, then the profits should thus be wholly sourced from Hong Kong. Such a view was echoed by the BOR in *D7/08* and the IRD in DIPN 21, para 44.

(4) The fact that C Ltd neither had any staff nor a permanent office in Hong Kong would not by itself render its profits wholly offshore. As it engaged a secretarial company to perform various profit-producing activities on its behalf in Hong Kong, appropriate weight should be accorded thereto in determining the source of profits: see DIPN 21, para 17(j).

Analysis (2): Trading profit

Alternatively, C Ltd may be regarded as having derived trading profits outside Hong Kong because of the following:

(1) C Ltd purchased semi-finished parts from the Mainland Factory and resold them to B Ltd at a mark-up. Plainly, the profits earned by C Ltd were trading profits.

(2) In accordance with DIPN 21, the source of trading profits should be the place where the sale and purchase contracts were effected. If either contract was effected in Hong Kong, then the initial presumption is that the profits are chargeable to profits tax.

(3) B Ltd and the Mainland Factory, the only customer and the only supplier of C Ltd respectively, were not in Hong Kong. There is no evidence that they had any business presence in Hong Kong. C Ltd also did not have any office nor staff in Hong Kong. In the circumstances, it is likely that both the sale contracts (with B Ltd) and the purchase contracts (with the Mainland Factory) were effected outside Hong Kong.

(b) **The arm's length principle and transfer pricing methodologies**

The arm's length principle requires C Ltd to charge B Ltd a mark-up based on what it would have done in an uncontrolled transaction in comparable circumstances, so that C Ltd would be remunerated with a reasonable return on its co-ordinating work in Hong Kong.

In applying the above principle, the transactions between C Ltd and B Ltd should first be characterised. On the basis of such characterisation, an appropriate transfer pricing methodology would be selected and applied to determine the arm's length mark-up which C Ltd should charge B Ltd.

Three common transfer pricing methodologies include:

(1) Comparable Uncontrolled Price (CUP) Method;

(2) Resale Price Method; and

(3) Cost Plus Method.

As the products involved in the present case were electronic parts, which might not have any external market, the CUP Method and Resale Price Method are difficult to apply. The Cost Plus Method is therefore the one which the assessor may adopt in determining the arm's length mark-up earned by C Ltd.

HKICPA December 2010 (Amended)

6.6 Planning for business transactions

When a person enters into business transactions, the following are relevant considerations:

(a) particular interest of the parties;

(b) commercial considerations of the parties;

(c) profit motives of the parties;

(d) costs (including opportunity cost) involved in the transaction;

(e) legal issues of the transaction;

(f) timing of the transaction;

(g) methods of financing the transaction;

(h) contractual matters of the transaction; and

(i) taxation issues.

The following are examples of some common types of business transactions to illustrate the different ways of structuring a transaction that may have different tax consequences:

(a) purchase and sale of immovable property;

(b) purchase and sale of shares or assets of a business;

(c) buying or leasing an asset; and

(d) structuring borrowing for a development project.

6.6.1 Purchase and sale of immovable property

Recommendation: Use a shelf company to own immovable property in Hong Kong.

The conveyance on sale of immovable property in Hong Kong and the AFS of residential property in Hong Kong are chargeable with stamp duty. At present, the maximum rate of stamp duty is 4.25% on the higher of the stated consideration and market price. On the other hand, the rate of stamp duty on transfer of Hong Kong stock is only 0.2% (0.1% on bought note and 0.1% on sold note).

Using a shelf company to purchase immovable property in Hong Kong and then disposing of the shares in this property owning company can save stamp duty for the second purchaser. The following is an example of using a shelf company in a property transaction.

Scenario 1 - No shelf company		Scenario 2 - With a shelf company	
Mr A purchased a property at $10m and sold it at $12m in ten days.		Mr B used B Ltd to purchase a property at $10m and sold the shares in B Ltd at $12m in ten days.	
Stamp duty on purchase of property	$375,000 by Mr A (10m × 3.75%)	Stamp duty on purchase of property	$375,000 by B Ltd (10m × 3.75%)
Stamp duty on sale of property	$450,000 by the purchaser (12m × 3.75%)	Stamp duty on transfer of shares	$12,000 (0.1% on $12m) by Mr B $12,000 + $5 (on instrument of transfer) by the purchaser
Note: The SSD implications has to be considered if the residential property was acquired on or after 20 November 2010, either by an individual or a company (regardless of where it is incorporated), and resold within 24 months.			
Profits tax on sale of property	$300,000 by Mr A (12m – 10m) × 15%	Profits tax on sale of shares	Profits from the sale of shares in a special purpose company may be subject to profits tax (*D46/09*)
Total tax and duty	$1,125,000 (375,000 + 450,000 + 300,000)	Total tax and duty	$399,005 (375,000 + 12,000 + 12,000 + 5)

It should be noted that B Ltd should own one property only. Otherwise, the disposal of one property in its portfolio cannot be effected through a transfer of its shares.

The disadvantage of acquiring the shares in B Ltd is that the purchaser may suffer a loss from the undisclosed liability of B Ltd (e.g. pending litigation). Besides, if the property is regarded as the trading stock of B Ltd, its subsequent disposal will cause a tax liability to B Ltd, which will also be borne by the new owners of B Ltd.

Example 26

Gary is a US resident. After visiting Hong Kong several times, he decided to acquire a luxury property in Hong Kong for rental income purposes. He has the following in mind:

(1) He plans to finance 50% of the cost of acquisition with his own savings, while the remaining 50% of the acquisition cost will be financed by a loan obtained from a bank in New York. The loan will be secured by personal guarantee given by Gary.

(2) He plans to appoint a service company in Hong Kong as his agent to handle matters related to his letting activities.

(3) The property is to be let in a furnished state. He believes that furnishing the property is more likely to attract long term tenants. He estimates that he has to spend around $100,000 on refurbishing the property and providing the necessary furniture.

Gary is now debating whether to hold the property in his own name or in the name of a limited company incorporated in Hong Kong and wholly owned by him. However, he is unsure of the tax implications of each of the investment alternatives.

Required:

(a) Advise Gary how rental income derived from the property is to be taxed if the property is held in his own name or in the name of a limited company.

(b) Based on the information above, advise Gary which alternative is more tax advantageous to him. Your answer should include an analysis of the deductibility of loan interest, service fees paid to the agent and expenses incurred in connection with refurbishing the property as mentioned in (1) to (3) above.

Solution

(a) If Gary acquires the property in his own name, he will be subject to property tax at the standard rate (15%) on the net assessable value of the property.

Under s.2, the term ‘business’ is defined to include letting and sub-letting by corporations. Therefore, if Gary acquired the property in the name of a limited company, the rental income to be received will be subject to profits tax. As owner of the property, the company is also subject to property tax. To avoid double taxation, the company can apply to the IRD for an exemption from property tax under s.5(2)(a).

(b) If the property is held by Gary, he will be subject to property tax. The only deduction available to him is restricted to 20% of the assessable value of the property after the deduction of any rates paid by him. There will be no deduction of actual expenses incurred in respect of the property, including loan interest, service fees paid to the agent and other expenses incurred in connection with refurbishing the property.

If Gary wishes to claim a deduction of loan interest, he would have to elect for personal assessment. However, the eligible person must be either a permanent resident or temporary resident of Hong Kong. On the assumption that Gary continues to reside in the US after acquiring the property, the residence criteria will not be met. It follows that he will not be eligible for personal assessment and entitled to deduct the interest expenses.

If, however, the property is held by a limited company, it is entitled to the following tax deductions under profits tax:

Loan interest

In the present case, the loan was obtained to finance the acquisition cost of the property, which is held for producing rental income chargeable to profits tax. In this regard, the interest on the loan is incurred in the production of assessable profits, i.e. it fulfils the conditions of s.16(1)(a).

The relevant condition under s.16(2) is subsection (d). The loan was obtained from a bank in New York. It is most likely that the bank would be accepted as an overseas FI for the

purpose of s.16(2)(d). As the bank loan is not secured by any deposit, the condition in s.16(2)(d) should be satisfied, and the interest incurred is deductible. Sections 16(2A), (2B) and (2C) do not apply.

Service fees paid to the agent

For profits tax purposes, expenses are deductible if they are incurred in the production of the taxpayer's chargeable profits: s.16(1). As the service fee was incurred for producing rental income chargeable to profits tax, the expense satisfies s.16(1) and is deductible.

Expenses incurred on refurbishing the property and furniture

The expenses are capital in nature and therefore non-deductible under s.17(1)(c). However, the company is entitled to commercial building allowance on the expenditure incurred on refurbishing the property (4% on cost per each year of assessment). In respect of the expenses on furniture, the company is entitled to claim depreciation allowance in respect of the assets.

As more deductions will be available under profits tax, it is advantageous for Gary to hold the property through a limited company.

HKICPA May 2006 (Amended)

6.6.2 Purchase and sale of shares or assets of a business

An incorporated business can be acquired by purchasing all its assets or its shares. There are different implications to both the vendor and the purchaser in respect of each form of acquisition.

(a) **Purchase and sale of shares**

Purchasing all the issued shares in an incorporated business, in general, appears to be simpler for the purchaser since only one type of property needs to be transferred.

The transfer of shares in a company incorporated in Hong Kong or a company incorporated elsewhere with a share register kept in Hong Kong will be chargeable with stamp duty (0.1% on the bought note and 0.1% on the sold note, on the higher of the stated consideration or market price and $5 on the instrument of transfer). If the company being acquired owns immovable properties in Hong Kong, buying its shares instead of its assets may result in a saving of stamp duty (as discussed in **section 6.6.1** above).

Since the business is transferred as a going concern, tax liability (and also other contingent liabilities) of the vendor's trading activities is likely to arise after the business changes hands. A provision for the final tax liability needs to be made after taking into account the provisional profits tax already paid by the vendor. To protect the interest of the buyer, it will be prudent to request the vendor to provide an indemnity in case the actual liability exceeds what is expected from the disclosed information of the business.

If there is a tax loss, the IRD may not allow future set-off of such loss if they are of the view that the sole or dominant purpose of the change in shareholding is for the loss set-off (s.61B). The purchaser of the shares needs to support his purchase with reasonable commercial reasons. Advance ruling with regard to s.61B may be applied for before the share transfer.

One disadvantage to the purchaser of the shares in an unincorporated business is that there is no deduction for interest on money borrowed to acquire the shares which is capital in nature. Another issue of concern is the hidden loss or liabilities of the business (e.g. bad debt loss, pending litigation, additional assessments by the IRD for previous years). In general, the vendor would provide a personal guarantee or other forms of security to effect the deal. The purchaser needs to evaluate the securities provided by the vendor and the risk associated with the purchase of shares.

To the vendor, any unpaid tax liability of the business will go with the new owner. The gain on disposal of the shares is likely to be of a capital nature and therefore outside the scope of

charge to profits tax. However, profits from the sale of shares in a special purpose vehicle may be subject to profits tax: see *D46/09*. There will be stamp duty (0.1% on sold note) on the share transfer.

(b) **Purchase and sale of assets of a business**

From the purchaser's point of view, buying the assets of a business has the following advantages:

(i) only selected assets will be acquired;

(ii) only selected debts will be taken over;

(iii) no inheritance of the vendor company's tax problems;

(iv) no inheritance of the reduced written down value of the assets;

(v) entitlement to initial allowance on machinery or plant;

(vi) cost of goodwill may be allocated to assets ranking for depreciation allowances or prescribed fixed assets ranking for a full deduction; and

(vii) interest on money borrowed to acquire business assets is, in general, tax deductible.

The advantages to the purchaser are often disadvantages to the vendor. The vendor may be chargeable on the balancing charge on the assets being disposed of. He will need to settle the tax liability on cessation of business and there will be further costs for liquidating the company. However, any capital gain on disposal of the assets is not taxable.

The following issues may be considered in planning a sale or purchase of business assets:

(1) **Cash**

In general, cash will not be taken over by the purchaser and there is no tax implication as the transfer will be on face value resulting in no gain or loss. However, gain or loss may be realised if the sum of money is in foreign currency.

For the vendor, if the money represents the company's trading receipt or circulating capital, the exchange gain is taxable.

For the purchaser, if the foreign currencies are acquired for general trading purposes, any future exchange loss is allowable.

(2) **Trade debts**

Trade debts are likely to be transferred at a discount for any future bad debts and collection charges.

For the vendor, bad debts are deductible provided they are irrecoverable during the basis period. For the purchaser, the debts taken over are capital in nature. Any bad debt loss suffered in future will not be deductible.

(3) **Trading stock**

Pursuant to s.15C, trading stock at the date of cessation of business shall be valued at the amount realised or consideration given for the transfer if the stock is sold or transferred for valuable consideration, and the purchaser will deduct the cost of the stock in computing his profits chargeable to tax. In any other cases, the stock will be valued at open market value on the date of cessation.

For the vendor, any gain on disposal of the trading stock is taxable and any loss on disposal is allowable.

For the purchaser, if the trading stock taken over remains as trading stock in his business, the cost of the stock is deductible in computing his profits chargeable to tax. If the trading stock of the vendor (e.g. a car) is acquired by the purchaser as a fixed asset, the cost of the asset is not deductible but may rank for depreciation allowances.

(4) **Investment in shares**

The purchaser may take over the vendor's investment in shares. If the shares are Hong Kong stock, the transfer will be chargeable to stamp duty (0.1% on the bought note and 0.1% on the sold note, on the higher of the stated consideration or market price and $5 on the instrument of transfer).

For the vendor, the profit on disposal will be taxable if the shares are held for trading purposes.

For the purchaser, the purpose of acquiring the investment in shares should be properly documented (e.g. stated clearly in the minutes of the Board of Directors' meetings). If the shares are acquired as trading stock, future profits on disposal will be taxable. If the shares are acquired for long term investment purposes, future gains on disposal will be exempt from profits tax pursuant to s.14.

(5) **Machinery or plant**

A purchaser will generally prefer to allocate the maximum amount of the purchase price to machinery or plant as he will be entitled to initial and annual allowances on the consideration for the machinery or plant. He will also prefer to make the maximum allocation of the consideration to assets ranking for a full deduction (e.g. computer hardware, manufacturing equipment) or those ranking for 30% annual allowance (e.g. motor vehicles).

On the other hand, the vendor will prefer to allocate a minimal amount of the consideration to machinery or plant in order to minimise the amount of balancing charge (the cap of which is the aggregate of the initial and annual allowances granted on such machinery or plant). If the sale proceeds of the machinery or plant exceed the original cost of the assets, the capital gains are not taxable.

If the purchaser and the vendor are related, the Commissioner may invoke s.38B or s.16G(3)(c) to determine the true market value of the assets being transferred.

As the vendor and the purchaser clearly have opposite goals, the price of each asset will have to be determined by mutual compromise. It is important for both the purchaser and the vendor to state clearly the price allocated to various classes of assets in the sale and purchase agreement. Otherwise, the Commissioner may invoke s.38A to determine the cost of individual assets sold for one price.

(6) **Land or building**

Any conveyance on sale of immovable property (or AFS of residential property) in Hong Kong is chargeable with stamp duty. The amount of stamp duty ranges from $100 to 4.25% on the higher of the stated consideration and market value of the property. In general, stamp duty on conveyance on sale of a property (or AFS of residential property) is paid by the purchaser of the property.

There will be a balancing change on the vendor if the sale price of the building (not land) exceeds the residue of expenditure of the building.

For the purchaser, there is no initial allowance for a used industrial building. If the building continues to be used as an industrial building or a commercial building, the purchaser can claim annual allowance on the building based on the residue of expenditure after sale (residue of expenditure before sale plus balancing charge or less balancing allowance, if any).

(7) **Intangible assets**

If the purchaser acquires the business as a going concern, the price paid by him often includes a value for the goodwill of the business. Unfortunately, there is no tax relief (allowable deduction or depreciation allowance) for the cost of goodwill. In order to obtain a tax relief, the purchaser should seek to allocate the goodwill cost to assets ranking for depreciation allowances or PFAs ranking for a full deduction.

For the vendor, the sale proceeds of goodwill are capital in nature and not taxable.

If the purchaser acquires IPRs such as patent rights, rights to know-how, copyright, registered design or trade mark from the vendor, and the vendor is not related to the purchaser, he may claim a deduction of the cost pursuant to ss.16E and 16EA. For the vendor, if a deduction had been previously allowed on the costs of the IPRs, the sale proceeds, up to the amount of deduction previously allowed (as from the year of assessment 2011/12), are fully taxable.

Moreover, the registration cost of a trade mark, design or patent used in the production of chargeable profits is deductible under s.16(1)(g).

(c) **Making a decision on disposing of the shares or assets of a business**

In making a decision, the vendor should compare the net results of a sale of shares with that of an asset sale. A cash flow analysis is recommended although the discounting factor (i.e. the time value of money) may be ignored for simplicity of calculation.

When shares are sold, the calculation is simple. In general, there is no tax payable on the gain on disposal of shares. The outgoings are the transaction cost of the legal documents and stamp duty on share transfer.

The calculation of the after-tax proceeds of an asset sale is more complex. There may be further costs to wind up the company after disposal of its assets.

The following steps may be followed to calculate the net results of an asset sale:

(i) determine the date of cessation of the business;

(ii) allocate the global purchase price among the assets sold based on the agreement with the purchaser;

(iii) compute the balancing charge or allowance on the assets being disposed of;

(iv) determine the taxable profit and allowable deductions;

(v) compute the tax liability on the cessation of business after considering the provisional profits tax already paid; and

(vi) deduct the transaction costs, final tax liability and future winding-up costs from the global purchase price to arrive at the net proceeds from the asset sale.

The net proceeds from the asset sale can then be compared with the net proceeds from a sale of shares.

6.6.3 Buying or leasing an asset

If a taxpayer needs an asset for use in the production of chargeable profits, he can purchase or lease it. If the asset is acquired, the taxpayer may claim interest on the loan borrowed to finance the acquisition and deprecation allowance or a full deduction. If the asset is leased, the lease rental is deductible.

Example 27

Background information

Company A needs an asset (cash price $1,000) for use in its business. It may borrow $500 (repayable by the end of the fifth year) at 10% per annum to acquire the asset or lease the asset at $250 per annum for five years. The asset will rank for a full deduction in the year of purchase.

The projected profit (loss) of Company A before buying or leasing the asset is as follows:

Year	*Projected Profit (Loss)*
	$
1	500
2	500
3	1,000
4	1,000
5	1,000

Scenario 1 - Buy the asset						
Year	Taxable profit/(loss)		Net assessable profits after loss set-off		Tax at 16.5%	
	$		$		$	
1	(550)	[500 –1,000 – 50]	Nil		Nil	
2	450	[500 – 50]	Nil	[450 – 550 = -100]	Nil	
3	950	[1,000 – 50]	850	[950 - 100]	140	[850 × 16.5%]
4	950	[1,000 – 50]	950		156	[950 × 16.5%]
5	950	[1,000 – 50]	950		156	[950 × 16.5%]
Total	2,750		2,750		452	
Scenario 2 - Lease the asset						
Year	**Taxable profit/(loss)**		**Net assessable profits after loss set-off**		**Tax at 16.5%**	
	$		$		$	
1	250	[500 – 250]	250		41	[250 × 16.5%]
2	250	[500 – 250]	250		41	[250 × 16.5%]
3	750	[1,000 – 250]	750		123	[750 × 16.5%]
4	750	[1,000 – 250]	750		123	[750 × 16.5%]
5	750	[1,000 – 250]	750		123	[750 × 16.5%]
Total	2,750		2,750		451	

While the amount of the total tax payable remains the same in both cases, the tax payable in each year differs and there will be an impact on the projected cash flow of the company.

6.6.4 Structuring the borrowing for a development project

In *Wharf Properties Ltd*, the Privy Council ruled that interest on money borrowed to develop a property for future rental income, being capital in nature, was not deductible,

Under s.40, interest expenses incurred during the period of construction form part of the cost of construction. Initial allowance may be claimed if the property under development is an industrial building. There is no initial allowance available for a commercial building during the period of construction.

The effective cost for the financing of a development project is therefore higher than that for other borrowings because of the non-deductibility of interest expenses during the period of construction.

One possible arrangement to reduce the amount of interest being capitalised during the period of construction is to negotiate with the financiers/money lenders so as to obtain low interest rate loans during the period of construction and comparatively higher interest rate loans after completion of the development project. However, the arrangement may be challenged under s.61A if the sole or dominant purpose of entering into the transaction is to obtain a tax benefit.

6.7 Action plan

As long as tax planning strategies are formulated, it is necessary to plan for implementing all the necessary steps to achieve the intended results. The key words for structuring an action plan include ***when, where, who, how*** **and *why.***

The following steps may be taken in preparing an action plan:

(1) Determine the time frame of the arrangement. For example, a finance lease for five years.

(2) Determine the role of the parties involved. For example, A Ltd is the lessor, B Ltd is the lessee who will be paying $1,000 per annum to A Ltd for five years.

(3) Restudy the feasibility of the arrangement. Check to confirm that the proposed arrangement is workable without infringing any latest enacted anti-avoidance provisions. Seek professional (accountants', bankers' and lawyers') advice.

(4) Consider whether an advance ruling needs to be applied for before executing the arrangement.

(5) Analyse the logistics (flows of assets, money, information, etc.) and schedule the procedures. Determine who is to do what by when and how.

(6) Inform the parties involved. Explain why the arrangement is to be implemented and discuss the necessary procedures in carrying out the plan.

(7) Get commitment from all parties involved. Specify the responsibilities of each participant.

(8) Establish a report (co-ordination) system. Determine who should report to whom, by when, and how.

(9) Fix the time for periodic reviews.

6.8 Implementation and evaluation

An excellent plan cannot succeed without careful implementation and periodic reviews. Things can often go wrong without any significant warning signals. The following issues are important in carrying out the action plan:

(a) Arrange for the required transaction and prepare all the requested documents. For example, arrange funding for the purchase of the asset, buy the asset, execute the lease agreement, deliver the asset to the lessee, arrange lease payments, record the transaction in the books of accounts of the lessor and lessee respectively.

(b) Review the arrangement from time to time to ensure that it does not infringe any latest enacted provisions. Consider any change in the tax authority's attitude and evaluate the possible need for suspending or changing the original plan.

(c) Take steps to ensure that the plan will be carried out as originally planned. For example, inspect the asset to ensure that it is in good condition.

(d) Check the result of the transaction and compare it with that in the original plan. Find out the reasons for any discrepancy. For example, B Ltd has suffered a loss and could not benefit from the deductions of the lease payments.

(e) Take remedial actions, if any.

7 Advance ruling system

Topic highlights

There is no guarantee of success in tax planning. To ascertain the tax position of a contemplated transaction or arrangement, taxpayers may consider applying for an advance ruling from the IRD pursuant to s.88A.

A form (Application for Advance Ruling (Form IR 1297)) can be obtained from the IRD by downloading the form from the IRD website (**www.ird.giv.hk**), by writing to the Chief Assessor (Special Duty) at GPO Box 11234 or by telephone at 2594 5028.

A fee has to be paid to the IRD for an advance ruling as specified in Schedule 10 of the IRO. The applicant for an advance ruling on anti-avoidance provisions (including s.9A) needs to pay $10,000

when he submits the application. If the time spent by the IRD in considering the application exceeds seven hours (or eleven hours in the case of s.9A), the applicant will need to pay additional fees computed on an hourly basis at the rate of between $1,000 to $1,330 per hour.

The following information has to be provided in applying for an advance ruling:

(a) details of the applicant (name, address and tax file number);

(b) details of the other parties to the transaction (name, address and tax file number);

(c) period(s) to which the ruling request relates;

(d) if the application is by a tax representative, written authorisation or notification of consent from the taxpayer to act on his or her behalf;

(e) the relevant facts of the applicant's case together with supporting documentation;

(f) the provision of the IRO upon which a ruling is sought;

(g) the proposition of law that relates to the issues raised in the ruling;

(h) copies of any professional advice already received regarding the proposed transaction;

(i) confirmation on whether a ruling request has been lodged about the arrangement for another period; and

(j) a draft of the requested ruling.

The completed Form IR 1297 together with requested supporting documents and specified application fee should be mailed to the Deputy Commissioner of Inland Revenue (Technical), 36/F, Revenue Tower, 5 Gloucester Road, Hong Kong.

The Commissioner will not issue a ruling if the matter on which the ruling is sought is:

(a) not seriously contemplated by the applicant;

(b) frivolous or vexatious; or

(c) similar to an arrangement currently in place which is the subject of a tax audit.

The Commissioner may refuse to issue a ruling if the ruling:

(a) is the subject of a return which has or is due to be lodged;

(b) is the subject of an objection or appeal (even if the objection or appeal is in relation to a person other than the applicant);

(c) requires the Commissioner to determine or establish any question of fact; or

(d) depends upon the Commissioner making an assumption in respect of a future event or other matter.

A ruling issued by the Commissioner will be legally binding on the Commissioner on condition that the taxpayer adheres precisely to the facts as outlined in the ruling request. If the actual arrangement is materially different from that contained in the application, or alternatively there was a material omission or misrepresentation in the application, the ruling will not be binding on the Commissioner.

The Commissioner also has the power to withdraw any ruling at any time by notifying the applicant in writing of the withdrawal and the reasons therefore. The ruling will remain in force until the end of the period indicated in the initial ruling, provided that the arrangement has been entered into or effected on or before the date of withdrawal of the ruling and that the taxpayer has disclosed in the tax return that he has relied on the ruling. In other cases, the ruling will cease to apply once it has been withdrawn.

However, it should be noted that the IRD has indicated that a ruling will generally not be valid for more than two years of assessments from the year of issue of the ruling.

DIPN 31 (Revised) provides guidance on the advance rulings system.

The IRD has selected some rulings of general interest for publication. These rulings could be found in the 'Publications and Press Releases'. of the IRD's website: **http://www.ird.gov.hk/eng/ppr/arc.htm.**

Appendix 1

Tax cases on the application of s.61

Taxpayer	Subject matter	Reference
Rico Internationale Ltd	Genuine commercial purpose	(1965) 1 HKTC 229
Kum Hing Land Investment Co Ltd	Genuine commercial purpose	(1967) 1 HKTC 301
Douglas Henry Howe	Genuine commercial purpose	(1977) 1 HKTC 936
Stanley So & Co	Genuine commercial purpose	(2004) 1 HKRC 90-131

CIR v Rico Internationale Ltd [(1965) 1 HKTC 229]

The taxpayer was engaged in export business. It credited $211,038 to an associated company as 'service charge' while the services were in fact carried out by another associated company. It also credited commission of $759,924 to another associated company in the United States of America that acted as its agent. The IRD was of the view that the transaction relating to the service charge was a 'sham' but agreed to allow $40,775, the actual cost to the second associated company. Concerning the commission, the IRD only allowed $625,030, being the actual amount incurred by the American company on behalf of the taxpayer.

The BOR confirmed the Commissioner's determination in relation to the service charge but allowed the full deduction of the commission of $759,924. The High Court confirmed the BOR's decision on the 'service charge' but was of the view that only $625,030 was allowable in relation to the commission. The COA also decided in favour of the Commissioner.

Kum Hing Land Investment Co Ltd [(1967) 1 HKTC 301]

The taxpayer was appointed to take charge of the letting of the ground and first floors of Paterson Building and Great George Building, Paterson Street, Causeway Bay. One of the directors of the taxpayer, who was also the precedent partner of a dormant partnership, suggested that tenants might be sought in Japan. A representative of the taxpayer went to Japan and arranged a tenancy with Hong Kong Daimaru Department Store Co Ltd. The taxpayer paid $300,000 to the partnership as commission. The IRD was of the view that the transaction between the taxpayer and the partnership was an artificial transaction used to reduce the tax liability of the taxpayer and invoked s.61.

The BOR, by a majority, decided in favour of the Commissioner that the transaction was artificial or fictitious. The High Court also held that as the payment was not one which a businessman could reasonably be expected to make in the circumstances, the transaction was both artificial and fictitious. The commission payment was non-deductible notwithstanding that payment was actually made and properly evidenced.

CIR v Douglas Henry Howe [(1977) 1 HKTC 936]

In July 1971, the taxpayer, an author receiving royalties from Oxford University Press, incorporated a private company in Panama and entered into a contract of employment with that company under which he would devote his activity in writing books to earning royalties for the company in return for a salary of $12,000 per annum. The taxpayer's royalties at that time approximated $160,000 per annum. Later in the same year, another agreement was made by the taxpayer to assign the benefits of all royalties to which he was entitled to the Panama company for $1. When he entered into the agreement, the royalties were of a value of $1,210,000. The IRD was of the view that both the contract of employment and the assignment of royalties were artificial and fictitious and invoked s.61.

The BOR decided in favour of the taxpayer. Transfer of business by an individual to a company wholly owned by him, albeit for tax purposes, was not commercially unreasonable or unrealistic

and therefore not artificial. A fictitious transaction should be one which the parties to it never intend to carry out. Hence, neither of the transactions was artificial nor fictitious within the meaning of s.61. The High Court also decided in favour of the taxpayer.

So Kai Tong Stanley trading as Stanley So & Co [(2004) 1 HKRC 90-131]

The taxpayer was a sole proprietor carrying on business as a certified public accountant. The taxpayer paid an annual management fee of $810,000 to his service company. There was no written agreement and no fixed date for payment of the management fee. Section 61 was applied and the IRD disallowed certain expenses (including equipment rental, office facilities charges and entertainment expenses) claimed to have been incurred for 1996/97 and 1997/98.

On appeal to the BOR, the BOR allowed a part of the expenses but not the balance as the taxpayer was unable to demonstrate to the satisfaction of the BOR that the expenses were incurred in the production of his assessable profits. The taxpayer appealed to the CFI on the ground that the BOR refused to grant an adjournment to him for the purpose of producing further supporting details to support his deduction claim. The Court decided in favour of the Commissioner as it would only intervene where the decision of the BOR was inconsistent with a true and reasonable conclusion on the facts found.

Appendix 2

Tax cases on the application of ss.61 and 61A

Taxpayer	Subject matter	Reference
Yick Fung Estates Limited	Genuine commercial purpose	(2001) HKRC 90-112
Cheung Wah Keung	Genuine commercial purpose	(2002) HKRC 90-116
Asia Master Ltd	Genuine commercial purpose	(2006) HCAL 114/2005
Tai Hing Cotton Mill (Development) Ltd	Genuine commercial purpose	(2008) HKRC 90-198
HIT Finance Ltd	Genuine commercial purpose	(2008) HKRC 90-199
Shui On Credit Company Ltd	Genuine commercial purpose	(2008) HCIA 2/2007 & (2008) CACV 85/2008
Ngai Lik Electronics Company Ltd	Genuine commercial purpose	(2008) 1 HKRC 90-200 & (2009) 1 HKRC 90-217

Yick Fung Estates Limited [(2001) HKRC 90-112]

The taxpayer commenced its business of property development and investment in August 1969 (a pre-1974 business). In the year of assessment 1988/89, the taxpayer changed its accounting date from 30 June to 31 March. Two sets of accounts were prepared: one for the year ended 30 June 1988 and the second for the period of nine months from 1 July 1988 to 31 March 1989. The Commissioner computed the assessable profits for the year of assessment 1988/89 by reference to the profits made in the 21-month period from 1 July 1987 to 31 March 1989. The Commissioner opined that the taxpayer's change of accounting date with a view to drop out a large portion of its profits pursuant to s.18E was a transaction entered into for the sole or dominant purpose of obtaining a tax benefit, which was caught by s.61A.

The BOR (in *D44/97*) held that since the taxpayer's scheme (the change of accounting date) had no basis in its ordinary business, the taxpayer's reliance on s.18E (that the basis period of a pre-1974 business must be twelve months) was for tax avoidance. Section 61A can be applied to the taxpayer's case which permits an assessment for a period exceeding twelve months.

The CFI and COA also found that the taxpayer's change of accounting date had been for the sole or dominant purpose of enabling it to obtain a tax benefit and that s.61A should therefore apply. The taxpayer's argument that the mere change of its accounting date was not a 'transaction' was rejected by the BOR, the CFI and the COA; as 'transaction' is defined in s.61A(3) to include a scheme.

Cheung Wah Keung [(2002) HKRC 90-116]

The taxpayer is a controlling shareholder and director of First-Rate. Sun Ling is a motor car dealer. It has no relationship with either the taxpayer or First-Rate. For the years 1991 to 1995, Sun Ling and First-Rate entered into five annual service contracts whereby First-Rate agreed to authorise the taxpayer to be fully responsible for performing the contracts. In return, Sun Ling paid a fixed rate of monthly service fee, commission and special bonus to First-Rate. The Assistant Commissioner took the view that the interposition of First-Rate between Sun Ling and the taxpayer was a scheme entered into for the sole or dominant purpose of obtaining a tax benefit.

The BOR held that the transaction had no commercial reality and was therefore artificial within the meaning of s. 61 and should be disregarded. The BOR also concluded that the transaction was entered into for the sole or dominant purpose of obtaining a tax benefit and s.61A was applicable.

The taxpayer's appeal to the CFI was dismissed. The CFI found that the commission paid by a car dealer company to a company controlled by the taxpayer was indeed the taxpayer's income from employment and s.61 or s.61A was applicable.

The taxpayer appealed to the COA which held that whether a transaction which is commercially unrealistic must necessarily be regarded as being 'artificial' depends on the circumstances of each particular case and that commercial realism can be one of the considerations for deciding artificiality. To ascertain whether a transaction is artificial, it is thus necessary to scrutinise the terms of the particular transaction to be impugned and the circumstances in which it was made and carried out. Finally, the COA decided in favour of the Commissioner, and held that the taxpayer should be assessed to salaries tax.

Such an arrangement would now be caught by s.9A (discussed in **section 4.4** below).

Asia Master Ltd [(2006) HCAL 114/2005]

This was a tax investigation case followed by penalties imposed by the IRD.

Asia Master Ltd ('AML') was a Hong Kong incorporated company within the Asia Master Group of companies ('the Group'). The Group was a manufacturer and exporter of ceramics articles. AML was a trader in ceramics articles and was wholly owned by Asia Master Group Ltd ('AMGL'). The Group had trading companies in the USA and manufacturing arms in the Mainland, Asia Master (Panyu) Ceramic Industrial Ltd ('AM-PY'). An associated enterprise, A-Grade International Group Ltd ('AGIGL'), which was incorporated in the British Virgin Islands, was interposed between AML and AM-PY. Profit was siphoned off to AGIGL. The IRD issued estimated assessments under ss.61 and 61A to assess profits siphoned off to AGIGL. AML submitted that the Commissioner had acted outside her power under ss.61 and 61A in treating AGIGL's profits as those of AML because AGIGL's profits were entirely offshore in nature and not attributable to AML. AML argued that in applying s.61 to disregard artificial or fictitious transactions, 'the person concerned shall be assessed accordingly' and hence all parties, rather than just AML, should be taken into account.

The CFI disagreed with this and held that s.61 must be construed to limit to those present within the jurisdiction of the IRD. In respect of the s.61A issue, the CFI took the view that the interposition of AGIGL had caused a substantial reduction in the profits and tax liability of AML. The pricing arrangement between the parties involved was not set on an arm's length basis. The judge told AML to provide a benchmark or a comparable uncontrolled price before the argument could advance further. The judge shared the Commissioner's view that the transfer pricing report showed no analysis of the functions and risks of the relevant parties. The Court held that the Assistant Commissioner was empowered by s.61(2) to assess AML as if AGIGL was not involved. It was thus open to the Commissioner to raise an assessment on AML on the basis of direct sales between AML and AM-PY and to treat the entire profits of AGIGL as those of AML. The judge also took the view that even if part of the profits of the Hong Kong enterprise had originated from the Mainland enterprise, which had been assessed to tax in the Mainland in respect of the same profits resulting in economic double taxation, it would not make a difference in the ruling due to the lack of a comprehensive double taxation arrangement between Hong Kong and the Mainland during that time. The limited arrangement then in existence for the avoidance of double taxation on income had no application, since the BVI associated enterprise, AGIGL, was not a Mainland resident.

CIR v Tai Hing Cotton Mill (Development) Ltd [(2008) HKRC 90-198]

Tai Hing Cotton Mill Ltd ('Tai Hing') was a manufacturer of cotton spun yarn at Tuen Mun and had been carrying on its manufacturing business at a site ('the Land') for many years. On 18 December 1987, Tai Hing assigned the Land to its subsidiary, Tai Hing Cotton Mill (Development) Ltd ('Tai Hing Cotton'), which entered into a joint venture agreement with a subsidiary of Hang Lung Development Co Ltd to develop the Land into residential estates for trading purposes. The consideration for the Land consisted of an initial sum of $346,309,452, a further sum of $400 million subject to the purchaser realising net profits to meet such a payment and 50% of any additional profits. Market value of the Land was $800 million, and the total amount paid by Tai Hing Cotton was $1,084 million. The sale was considered as a tax avoidance scheme by the

Commissioner because the price of the Land would be deductible (subject to ss.16 and 61A) by Tai Hing Cotton but free of tax in the hands of Tai Hing because the Land was the latter's capital asset.

The BOR (in *D109/03*) decided that as the sale and purchase agreement, by itself, could not give rise to any profit, there could not be any tax benefit conferred upon Tai Hing Cotton by that agreement and so s.61A could have no application. The sale and purchase agreement could not be ignored as without it there would have been no redevelopment and hence no profit. Structuring of the consideration in this manner was commercial, as it was not uncommon between unrelated parties; and the arrangement could not have been undertaken to secure a tax benefit.

On appeal, the CFI decided in favour of the Commissioner and held that there was no requirement for the IRD to identify a pre-existing liability which was reduced by the transaction; and any reduction in tax could be considered a tax benefit. The payment of an otherwise deductible amount was a tax benefit even though the BOR had found as a fact that the amount was commercially realistic. The portion of consideration in excess of the market value of the land should be non-tax deductible by 'purposive interpretation' of s.16(1).

The CFI's decision was overturned by the COA. The COA held that the BOR's finding as to the sole or dominant purpose for entering into the transaction was one of fact which could not be overturned by a court unless clearly erroneous or perverse; and there was nothing to suggest that this was the case before them. The judge in the lower court was not entitled to substitute his own view as to the sole or dominant purpose for that of the BOR. Therefore, it was not necessary for the Court to consider the issue of whether an overall commercial purpose will prevent the application of s.61A. The taxpayer's appeal was allowed as the BOR found that the consideration paid for the Land was commercially realistic and not excessive.

The CFI's decision was reinstated by the CFA. Lord Hoffmann, a non-permanent judge of the CFA, ruled the BOR was wrong in trying to determine whether a tax benefit arose purely by referring to the subsidiary's immediate tax position with or without the land transfer. Section 61A is concerned with transactions which 'have the effect' of conferring a tax benefit and, accordingly, if the transaction permitted or facilitated the derivation of a tax benefit at a later date in connection with a subsequent transaction it could still potentially attract the application of s.61A. Accordingly, "*if the effect of the transaction is that your liability to tax is less than it would have been on some other appropriate hypothesis, you have had a tax benefit*". The transaction was capable of conferring a tax benefit on the taxpayer because of the ability to deduct a higher price for the land than its market value. Lord Hoffmann took the view that the parties were plainly not dealing at arm's length as they were parent and subsidiary, "*the same enterprise under the same direction in economic terms*". Moreover, the purpose of the transaction was to *"mop up … a portion of the taxpayer's profit … and transfer them tax free to Tai Hing"*.

The CFA held that under s.61A(2)(b), the Commissioner could assess the taxpayer on the hypothesis that there was a transaction which created income, but without the features which conferred the tax benefit. However, it was not open to the Commissioner to simply identify the alternative which gave the highest tax liability. It was necessary to decide what the most likely course of action would have been in the absence of the impugned transaction (the **'appropriate alternative hypothesis'**). Had the terms of the sale not been set on a profit participating basis, the most likely course of action would have been for the sale of the Land to have been undertaken at its market value and the tax consequences of such were to be used as the benchmark against which the tax benefit of the transaction was to be measured for the purpose of applying s.61A. Finally, Lord Hoffmann concluded that the deductible amount to Tai Hing Cotton should be the market value of the Land on the date of transfer.

CIR v HIT Finance Ltd [(2008) HKRC 90-199]

The taxpayer together with its group companies have entered into a group reorganisation scheme where the taxpayer issued loan notes overseas and on-lent a smaller amount of fund so raised to its group company. Lord Hoffmann in the CFA noted the taxpayer had issued loan notes in an amount three times as much as what could be taken by the market and its overseas group company had subscribed 2/3 of the loan notes. He concluded that the evidence suggesting some non-tax purposes of the arrangement was sparse and unconvincing. Therefore, the CFA held that

the transaction was entered into with the sole or dominant purpose of obtaining a tax benefit, and upheld the s.61A assessment on the taxpayer. For the similar reason given in *Tai Hing*, the CFA rejected the taxpayer's submission that one should compare the position of the taxpayer with what it would have been if there had been no transaction. The Court took the view that the Commissioner can question any transaction entered into by any person as long as any feature or component of the transaction is tax-tainted.

Shui On Credit Company Ltd [(2008) HCIA 2/2007 & (2008), CACV 85/2008 & (2009) and FACV 1/2009]

The taxpayer and its group company have entered into a group refinancing scheme whereby the taxpayer had incurred $600 million, which was described as a 'deferred expenditure' to purchase an interest income stream from a related party. The BOR (in *D60/05*) found that the implementation of the sub-participation scheme involved an artificial and circular flow of funds. The BOR ruled that there was a dominant purpose to obtain a tax benefit under such scheme. The CFI agreed with the BOR and held that the scheme was entered into for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit of a tax deduction of the $600 million consideration for the interest income stream and hence s.61A is applicable. The sum of $600 million was also held capital in nature and hence not deductible by virtue of s.17(1)(c). The COA and the CFA dismissed the taxpayer's appeal. The COA held that since the sum was disallowed under s.17(1)(c), there was no tax benefit and so s.61A was not applicable.

Ngai Lik Electronics Co Ltd [(2008) 1 HKRC 90-200, (2009) 1 HKRC 90-217]

The taxpayer ('NLE'), which was a Hong Kong based company, was part of the Ngai Lik Group. The taxpayer subcontracted the production of components for audio equipment to other members of the group, including Din Wai Electronics Ltd ('DWEL') and Shing Wai Ltd ('SWL'). Both were BVI companies operated in the Mainland. Customers would place orders for audio equipment with NLE, which would then order equipment with DWEL. The sale price of the goods from DWEL to NLE was not set until subsequently determined. DWEL would in turn order from the Mainland manufacturers, including SWL and another group company, Ngai Wai Plastic Manufacturing Ltd ('NWPM'). Over 96% of the sale of SWL and NWPM would be made to DWEL. Bulk discounts determined annually, in addition to normal discounts, would be given to DWEL such that it would not fall into deficit. NLE provided certain services to DWEL, SWL and NWPM relating to the manufacturing activities of these companies, and was entitled to a service fee under certain agency agreements.

The BOR (in *D83/06*) took the view that the method of price setting between DWEL and NLE would result in manipulation of NLE's profits. Additional annual discounts given to DWEL did not adhere to any formula and were arbitrary in nature. Such discounts were used to distribute profits among the parties. Moreover, the service fee payable to NLE was not sufficient to cover its costs. Having considered the seven matters in s.61A(1)(a) to (g), the BOR found that the implementation of a scheme to allocate profits by NLE to other companies was for the dominant purpose of obtaining a tax benefit. The CFI agreed with the BOR's decision, with particular support to the BOR's findings that the pricing mechanism was a means to obtain a tax benefit.

The judgment of the COA unanimously upheld the BOR's decision and the CFI's judgment. However, the judgment was overturned by the CFA. The COA's views in relation to s.61A are summarised as follows:

(a) **Section 61A assessments are distinct and different from s.14 assessments.** The main issue of the appeal is whether s.61A can extend the territorial ambit of the IRO to assess profits from offshore businesses that are otherwise not chargeable under s.14, rather than whether the profits in question are chargeable under s.14. The COA took the view that as far as a scheme falls within the scope of s.61A, such assessments are lawful under s.61A(2) as they are directed at counteracting the perceived tax benefit conferred by the scheme. The s.61A assessments in this case were raised for anti-avoidance purposes to tax what would be NLE's assessable profits should the tax benefit obtained by NLE be counteracted, rather than to tax the offshore profits from the BVI subsidiaries.

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(b) **Existence, but not quantification, of a tax benefit is necessary for the application of s.61A.** The COA's judgment confirms that s.61A can be applied when the sole or dominant purpose of a transaction is to confer a tax benefit. It is therefore sufficient to show that the scheme has the ability to confer a tax benefit and quantification of the tax benefit is not a pre-requisite to the application of s.61A.

(c) **What is considered as the sole or dominant purpose is a matter of fact.** The COA held that the BOR's conclusion that the dominant purpose of the scheme was to confer a tax benefit on NLE was not perverse and therefore cannot be disturbed.

These views were contrasted with those laid down in the decision of the CFA, which are summarised below:

The CFA took the view that the following three intersecting conditions must be satisfied before the Commissioner can exercise her power to raise an assessment under s.61A(2):

(a) a transaction (broadly defined to include an operation or a scheme) has been entered into;

(b) such transaction has, or would have had but for s.61A, the effect of conferring a tax benefit on the relevant person; and

(c) viewing the transaction by reference to s.61A(1)(a) to (g), it would objectively be concluded that it was entered into or carried out for the sole or dominant purpose of enabling the taxpayer to obtain a tax benefit.

If s.61A is to be applied, it is essential to identify with some precision what tax benefit is allegedly conferred on the taxpayer. The three interlocking conditions, transaction, tax benefit and sole or dominant purpose; must be properly aligned and approached with the necessary degree of precision if the application of s.61A is not to miscarry.

Where an assessment is raised under s.61A, it must be justifiable as a reasonable and proper exercise of the power.

The CFA opined that the formulation of the scheme for the purpose of s.61A by the BOR and the lower level courts was wrong. Such formulation consisted of two major parts: (i) on reorganisation of the taxpayer and its group's business that involved a transfer of business to various BVI companies in around April 1993 and (ii) on adoption of a transfer pricing policy after the transfer of business. The adoption of a transfer pricing policy involved three elements:

(a) the annual exercise of setting the sales price of finished goods from DWEL to NLE;

(b) the number of goods sold from DWEL to NLE is only recorded in actual quantities of goods ordered and delivered;

(c) the granting of additional bulk discounts from SWL/NWPM to DWEL after the year end.

In ascertaining how the scheme as formulated by the BOR and the lower level courts intersected with the tax benefit, the CFA took the view that the re-organisation steps did not produce any tax benefit. In addition, the granting of additional bulk discounts had clearly lacked any connection with the tax benefit. The additional discounts had no impact on the taxpayer's profit or its liability to tax at all.

Another deficiency in formulation of the scheme as identified by the CFA is the various references by the BOR and the lower level courts to manufacturing profits or profits from 'manufacturing-related activities'. The references were based on the Commissioner's contention that *"the effect of the Scheme was to reduce the amount of the profits (manufacturing and trading) of the taxpayer"*. The CFA took the view that the relevant manufacturing process had taken place outside of Hong Kong. Even if they were part of NLE's own business, the profits derived from those operations would not be chargeable to profits tax since they would have been sourced offshore. Also, the 'manufacturing-related activities' were at most ancillary and incidental to the offshore manufacturing operations. The references to 'manufacturing profits', etc. could not provide any foundation for the additional assessments raised under s.61A.

The CFA also pointed out that it was wrong to raise additional assessments under s.61A on NLE for the years of assessment 1991/92 and 1992/93 because the transfer of business to the BVI companies took place 'in around April 1993'.

Having identified the deficiencies of the BOR's formulation of the scheme and the tax benefit, the CFA took a notional amendment to strip away the deficiencies, finding that it is permitted to do so based on the Australian High Court's decision in *Federal Commissioner of Taxation of the Commonwealth of Australia v Peabody* and s.61A(2)(a). Section 61A(2)(a) permits the Commissioner to fashion her assessment as a response to 'any part of' a transaction. The CFA took the view that such notional amendment had caused no procedural unfairness to the taxpayer.

The CFA then preceded its decision on the basis of a narrower scheme (Narrower Scheme), which is confined to:

(a) the annual exercise of setting the sales price of the finished goods from DWEL to NLE, and

(b) the number of goods sold from DWEL to NLE only recorded in actual quantities of goods ordered and delivered;

and a narrower tax benefit, which is confined to NLE's trading profits and ignoring references to profits passed on to the fellow subsidiaries.

The CFA opined that even though the sums made by NLE to DWEL was not at arm's length and was excessive, such sums could be deductible under s.16 and were not disallowed under s.17. The reason is s.16 allows deductions of 'all outgoings and expense' to the extent incurred during the relevant basis period in the production of assessable profits, and the sums paid could not be said to be an 'expense not being money expended for the purpose of producing … profits' so as to be excluded by s 17(1)(b). The CFA stated that ss.16(1) and 17(1)(b) do not require the Commissioner to compare the purchase prices deducted against the market prices and to disallow deductions considered excessive. The CFA concluded that NLE did successfully alter its tax liability in that the Narrower Scheme enabled it to make those deductions which, but for s.61A, would have the effect of conferring a tax benefit on NLE. Section 61A is therefore engaged.

The CFA took the view that the price-fixing arrangement (the Narrower Scheme) was entered into with DWEL for the dominant purpose of obtaining a tax benefit for NLE, with regard to the seven matters listed in s.61A(1)(a) to (g), noting that the statutory purpose of s.61A is not to attack arrangements made to secure tax benefits which are legislatively intended to be available to the taxpayer. The CFA stated that paragraphs (d), (e) and (f) of s.61A(1) were of particular importance to that conclusion. It was clear that DWEL and NLE were not dealing with each other at arm's length. The prices at which DWEL sold the finished audio products to NLE were determined by NLE's accounting department as an intra-group arrangement at the end of each year. The change caused by the Narrower Scheme to the financial position of NLE's Group was 'None'. Therefore, the CFA concluded that s.61A was engaged, but only in relation to the three years from 1993/94 to 1995/96, after the Narrower Scheme had occurred.

The CFA further stated that once it is established that s.61A(1) applies, the Commissioner comes under a duty to raise an assessment with the provisions of s.61A(2). As explained in *Tai Hing*, there are two options under s.61A(2). First, under paragraph (a) of s.61A(2), the taxpayer is assessed as if the transaction had not been entered into or carried out. Alternatively, under paragraph (b), the assessment must be designed 'to counteract the tax benefit which would otherwise be obtained'. With reference to *Tai Hing* and *HIT Finance*, the CFA opined that for the purposes of s.61A(2)(b), the power must therefore be exercised on the basis of a reasonably postulated hypothetical transaction which produces an assessment designed rationally to counteract the tax benefit. The assessment cannot be raised in some arbitrary amount or arrived at upon some basis that is unreasonable or not rationally related to the tax benefit in question.

The CFA took the view that the exercise of the power under s.61A(2) has been seriously miscarried in this case. The additional assessments, which were initially raised by the Commissioner, purported to treat the whole of the profits of NLE's fellow subsidiaries, including the three BVI companies, operating on the Mainland, as NLE's chargeable profits. Subsequently, those assessments were reduced by 50%. The additional assessments were not raised under s.61A(2)(a)

because they were not raised on the basis that the price-fixing arrangements had not been entered into or carried out. The CFA opined that the Commissioner had raised the additional assessments by virtue of s.61A(2)(b), in a way to counteract the tax benefit. However, the CFA opined that to counteract the tax benefit, a reasonable approach should be to raise an assessment on the profits which would hypothetically have been earned if the taxpayer had purchased the goods at arm's length prices instead of at the prices fixed annually. The CFA took the view that it was impossible to see any rational connection between the figure adopted by the Commissioner for the additional assessments and the excessive prices allegedly paid by NLE to DWEL. The additional assessments seeking to charge NLE with half of the manufacturing profits of the four fellow subsidiaries do not rationally address or seek to counteract the tax benefit arising from the price-fixing arrangement between NLE and DWEL.

Therefore, the CFA annulled the additional assessments for the years 1991/92 and 1992/93. For the additional assessments relating to the years of assessment 1993/94 to 1995/96, the CFA remitted the case to the BOR and the Commissioner, with its opinion thereon and directed the Commissioner to raise fresh assessments on a proper basis in accordance with the CFA's judgment. Such fresh assessments should be aimed at counteracting the tax benefit derived from the price-fixing arrangement. It may be on the basis of an estimate of the assessable profits which would have been earned by NLE if it had hypothetically paid an arm's length price for the goods delivered by DWEL.

As a separate issue to its decision, the CFA mentioned that the case had demonstrated a clear need in s.61A proceedings before the BOR for the IRD to identify with workable clarity at an early stage the tax benefit which it seeks to challenge, the transaction which it says had the effect of conferring that tax benefit on the taxpayer and the person or persons having the relevant sole or dominant purpose. Such particulars should be provided as a matter of procedural fairness and to facilitate a sound analysis of the case.

As the provisions under s.61A and the anti-avoidance provisions under Part IVA of the Income Tax Act in Australia are similar, the decisions in the Australian Courts (*FC of T v Spotless Services Ltd & Anor* [96 ACT 5201]; *CC (NSW) Pty Ltd v FCT* [97 ATC 4123]; *Clough Engineering Ltd v FCT* [97 ATC 2023]; *Grollo Nominees Pty Ltd v FCT* [97 ATC 4585] would have an impact on the interpretation of s.61A in Hong Kong.

Appendix 3

Tax cases on the application of s.9A

D13/06

The taxpayer, a leading nuclear medicine radiologist, controlled Co W. Co W entered into a service contract with Co S, which is controlled by the Director of the Nuclear Medicine Department of a Hong Kong private hospital. Under the contract, Co W was to provide the service of the taxpayer to Co S. In turn, Co S entered into a contract with the private hospital to provide the service of the taxpayer to the hospital. The BOR held that the taxpayer failed to satisfy all the criteria under s.9A(3). He also was unable to satisfy the exclusion under s.9A(4). Therefore, the income earned by Co W from the hospital were deemed to be income derived by the taxpayer from employment and chargeable to salaries tax.

D78/06

The taxpayer was a major shareholder and a director of a private company ('ServiceCo'). ServiceCo entered into service agreements ('the Agreements') with Person A and Person B respectively, whereby the taxpayer would provide services to each of them. The BOR noted that the arrangement would result in more tax deductions as the deduction criterion under s.16(1) was less stringent than that under s.12(1)(a). It opined that s.61 was applicable as the arrangement was plainly artificial because there was no real role for ServiceCo apart from tax avoidance. In this regard, it was found that ServiceCo had no staff apart from the taxpayer and no salary was charged in ServiceCo's financial statements for the relevant years of assessment. The BOR also held that s.9A(1) was applicable and hence all income derived under the arrangement would be assessed as employment income. Moreover, the taxpayer was not eligible for the exclusion under s.9A(3) because the Agreements had the annual leave provision, the taxpayer did not provide service to persons other than Person A and B, the remuneration was, like employment income, paid or credited periodically, and the Agreements had the termination provision similar to that of an employment.

Appendix 4

Tax cases on the application of DIPN 24

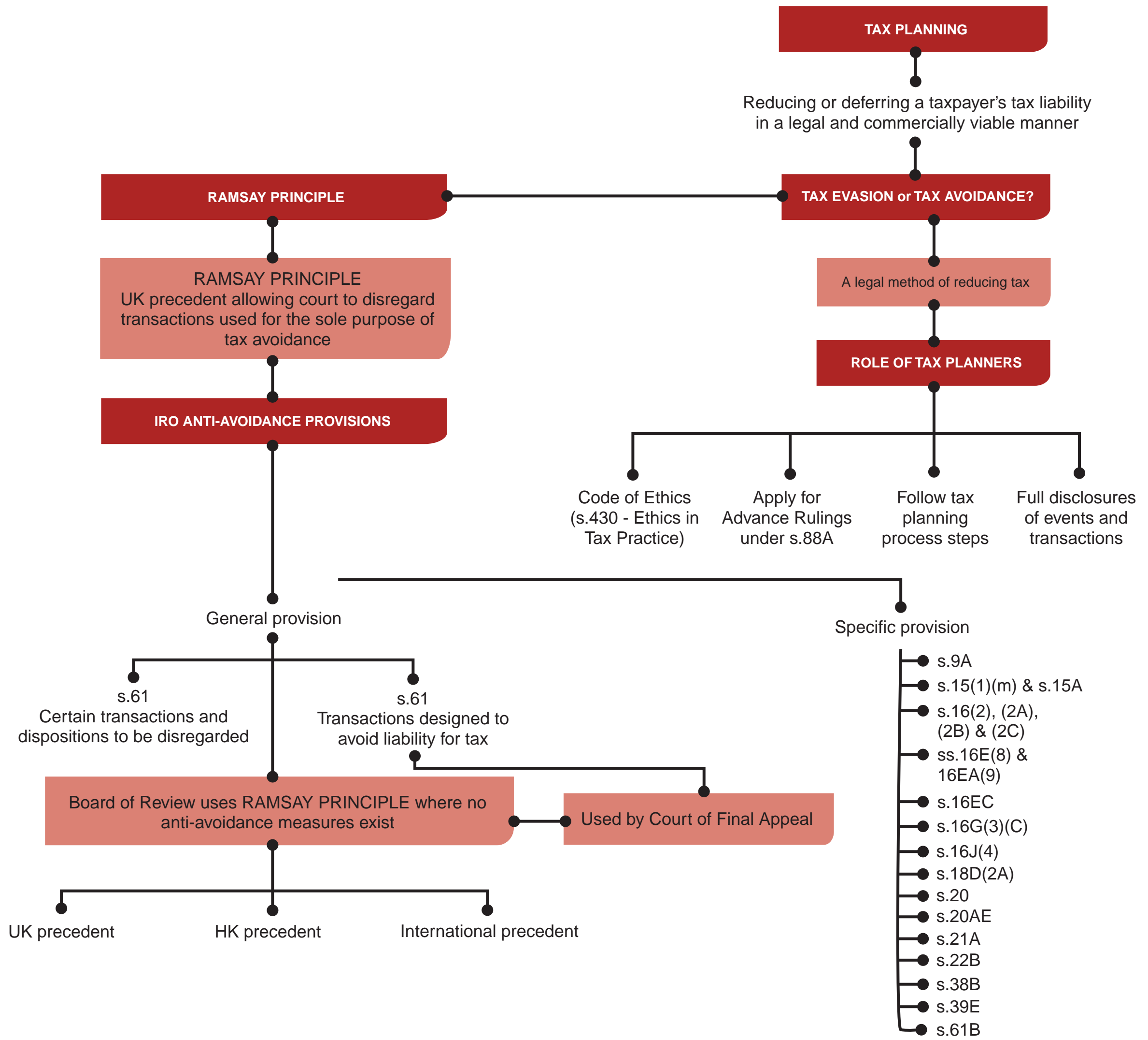
D62/01

The taxpayer, a solicitor firm, paid management fees to a service company. Pursuant to DIPN 24, part of the management fees was disallowed in computing the profits tax liability of the solicitor firm. The service company claimed that the management fees should be exempt from profits tax. The BOR held that DIPN 24 only deals with the deductibility of management fees to the UB; and has no application to the taxation of the service company. Even though the payment of management fees was commercially unrealistic, the transactions had commercial basis and the management fees were assessable under s.14.

D13/07

The taxpayer, a solicitor firm, claimed a deduction of management fees, which was said to have been incurred and payable to several service companies. The assessor only allowed a deduction to the extent that those costs directly attributable to the operation of the taxpayer plus an appropriate mark-up of 12.5%. The BOR found the service agreements between the taxpayer and the service companies were commercially unrealistic and artificial, in particular there was no evidence on how the monthly sums were arrived at. The BOR was of the view that s.61 applied to disregard the transaction, and contrasting to DIPN 24, the whole of the management fees charged should be disregarded. The BOR opined that it was not necessary to examine the service fee expenses and consider the extent to which any of the expenses should be allowed as a deduction.

Topic recap



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Answers to self-test questions

Answer 1

(a) **Tax implication to X Ltd:**

There is a doubt as to the purpose of setting up X Ltd. The information is not clear as to where the company carries on business and whether any tax liability, Hong Kong or elsewhere, is accrued. Under s.14, any person (i) carrying on a trade, profession or business in Hong Kong, (ii) derives profits from that trade, profession or business, other than profits arising from the sale of capital assets; and (iii) those profits arise in or are derived from Hong Kong, is subject to Hong Kong profits tax.

The place of incorporation is irrelevant in determining whether X Ltd is carrying on business in Hong Kong. The factors to be taken into consideration include the place where the board of directors meet and make decisions, the place where the company's day-to-day activities are conducted, etc. The information given is not sufficient to arrive at a conclusion as to whether X Ltd is carrying on business in Hong Kong. However, if X Ltd does not maintain a competent board overseas and is effectively managed and controlled in Hong Kong, it is very likely that X Ltd would be regarded as carrying on business in Hong Kong.

The information given is also not sufficient to determine whether the commission received by X Ltd is arising in or derived from Hong Kong. Factors to be considered should include the nature of the commission, the circumstances leading to the receipt of the commission, the place of negotiation and conclusion of the commission agreement, any staff involved in enabling X Ltd to earn the commission, and the place where the services are provided, etc.

(b) **Tax implication to X Ltd:**

The commission was expensed by Y Ltd in the year 2012. The question of whether or not the commission is deductible depends on whether the general principles under s.16(1) are satisfied. The general rule is that the expense must be incurred in the production of assessable profits.

Other than the fundamental test, the following criteria must be satisfied before a tax deduction is granted:

(1) The transaction between Y Ltd and X Ltd is on an arm's length basis, i.e. arranged as if both parties are unrelated third parties.

(2) The transaction is commercially justified, i.e. not entered into for the sole or dominant purpose to avoid tax.

(3) The services of X Ltd are provided for the benefit of Y Ltd in the production of Y Ltd's assessable profits.

(4) The amount charged is substantiated with calculations.

(5) The basis of charge is commensurate with the benefits accrued to Y Ltd and makes no reference to the profitability of Y Ltd.

(6) The amount is realistic, reasonable and not excessive.

(7) Documentation is properly put in place, including the commission agreement, relevant board minutes or resolutions, invoices, receipts, payment records and working papers to substantiate the calculations.

(8) The transaction is not artificial and fictitious.

Alternatively, the IRD may apply s.61 or s.61A to disallow the tax deduction of the commission paid by Y Ltd to X Ltd for the reasons that:

(i) the transaction was artificial and fictitious in nature; or

(ii) the transaction was entered into with the sole or dominant purpose of creating a tax benefit.

Answer 2

(a) Section 61B is used to restrict the trafficking of loss companies for the purpose of tax avoidance. It disallows loss set-off if the Commissioner is satisfied that the sole or dominant purpose of any change in shareholding in a loss company was for the purpose of utilising such losses to obtain a tax benefit.

Section 61B applies if:

(i) a change in shareholding has been effected after 13 March 1986;

(ii) the Commissioner is satisfied that as a direct or indirect result of the change, profits have been received by or accrued to the company during any year of assessment (i.e. not necessarily in the year subsequent to the change); and

(iii) utilisation of the loss is the 'sole or dominant' purpose of the change in shareholding.

'Effected' means shares are transferred from one person to another. The transferee may or may not be an existing shareholder, and the transferor may or may not continue to be a shareholder.

In deciding whether profits have been received, the flow of profits before or after the change will be examined in particular with reference to:

(i) nature and conduct of the company's business,

(ii) income and expenditure patterns,

(iii) management and control, and

(iv) background of the party to whom shares were transferred.

'Dominant purpose' means the purpose which outweighs all other purposes combined.

(b) Based on the facts provided, acquiring the shares in Sad Ltd can benefit Happy Ltd and is not for the dominant purpose of utilising the loss of Sad Ltd. Instead, the acquisition of two-thirds of the shares in Sad Ltd is intended to continue and expand the existing business of Sad Ltd into the China market. There is no change in the nature of business carried on by Sad Ltd after the share transfer. Therefore, if losses were sustained in the assessments of Sad Ltd in the previous years, they could be used to set off against the future profits accrued to Sad Ltd in the following year(s) after the share transfer.

Nevertheless, Happy Ltd should be aware of the possible challenge by the IRD on the basis of s.61B. It is advisable for Happy Ltd to obtain an advance ruling on the acquisition proposal in respect of the treatment of the losses brought forward, if it is going to take over the shares of Sad Ltd.

Answer 3

Section 9A is used by the IRD to challenge the use of a service company to disguise an employment relationship. Section 9A is applicable if the fees are paid to a service company for the service provided by an individual who (or his associate) controls the company. Section 9A can be applied to LL as LL is controlled by Richard who provides the same personal services to CKPL similar to those when Richard was employed by CKPL.

However, it is further provided that s.9A will not be applied if all the six criteria listed in s.9A(3) are satisfied. These criteria characterise a contract for service or professional service. Based on the

information provided in the question, the relationship between Richard and CKPL is likely to meet these criteria (e.g. Richard also provides services to other companies) and s.9A is unlikely to apply.

If s.9A applies, the income that LL received from CKPL will not be assessable under profits tax, but assessable under salaries tax as Richard's income from employment. CKPL will be required to fulfil the obligations as an employer as if Richard is its employee. However, the income that Richard derived from LL will not be taxable.

Answer 4

Mr. Young's plan, if put into effect, will leave Young Design with a profit of no more than 10% of its turnover, after charging a deduction for the consultancy fee ('the Fee') calculated at 90% of its turnover. The limited company, the Consultant, will have a consultancy fee income ('the Income') equivalent to 90% of Young Design's turnover against which expenses can be deducted before arriving at the Consultant's profits chargeable to tax. The deduction of expenses may include expenses which are otherwise not deductible from Young Design. As a result and if the IRD accepts Mr. Young's claims, he will pay less tax than he would without the arrangement.

To qualify as a deductible expense, Mr. Young must satisfy the IRD that the Fee fulfils the requirements of s.16(1). That is, (i) the Fee was incurred, (ii) it was incurred in the production of the chargeable profits of Young Design, and (iii) it was not excessive. It is, however, likely that the Fee will be challenged by the IRD as to whether requirements (i) (ii) and (iii) are fulfilled.

The IRD will likely probe into the commercial reality of the arrangement between Young Design and the Consultant. It will look at all surrounding circumstances: relationship between the payer and the payee, the purpose of / reasons for the payment, the manner of payment, the basis and breakdown of the amount. It may attack the arrangement and circumvent the tax benefits pursued by Mr. Young by invoking the provisions of ss.61 and 61A.

The IRD may look at matters such as whether the arrangement was properly documented, implemented and put into effect. If not, the arrangement can be disregarded as being artificial or fictitious under s.61.

The IRD may also apply the seven matters specified in s.61A to ascertain whether the sole or dominant purpose of the arrangement is to confer a tax benefit on Mr. Young. If this is so, the IRD will disregard the arrangement and assess Mr. Young and the Consultant in a manner considered appropriate to counteract the tax benefit sought by Mr. Young.

In the event that the IRD does not invoke s.61 or s.61A, it may still restrict the deduction of the Fee under s.16 by applying DIPN 24 (Service Company 'Type II' Arrangements), i.e. allow a deduction at the cost of qualifying services plus a mark-up at 12.5%. The relationship between the Fee and the services (and the cost thereof) rendered by the Consultant to Young Design in the production of the latter's chargeable profits will be examined. The Fee will be dissected in accordance with an analysis of the Consultant's expenses by which the cost of qualifying services is identified. In the case the Fee is an indivisible sum, the IRD may disallow the Fee in total.

To conclude, Mr. Young has to prepare himself for the attack of the IRD under ss.16, 61 and 61A. He may not enjoy the expected tax benefits.

Exam practice

Ocean Ltd — 36 minutes

Ocean Ltd carries on a general trading business in Hong Kong. It is the wholly owned subsidiary of Island Ltd, a company holding an investment property with a market value of $100 million in Hong Kong for rental purposes.

During the year ended 31 December 2012, Ocean Ltd has made a trading loss of $1 million while Island Ltd has made a handsome profit from letting the investment property at an annual rent of $5 million. It is expected that Ocean Ltd will continue to suffer a loss from its trading business in the coming year.

In order to reduce the amount of losses suffered by Ocean Ltd, Island Ltd, without obtaining any professional advice, decided to enter into an agreement with Ocean Ltd by paying $2 million per annum to Ocean Ltd as a service fee for property management and collection of rent.

Required:

(a) Explain what queries you may expect from the IRD in respect of the service fee arrangement. **(4 marks)**

(b) Explain the tax implications on the arrangement between the two companies. **(6 marks)**

(c) Instead of entering into the above agreement, what will be the tax implications if Ocean Ltd purchases the property (with existing tenancy) from Island Ltd at market value? **(10 marks)**

(Total = 20 marks)

Mr. X — 27 minutes

Being a director of A Ltd, Mr. X had a service agreement with A Ltd which merely provided him with base salary of $200,000 per month. In June 2012, A Ltd entered into an unstamped tenancy agreement with Mr. X whereby Mr. X would let his solely-owned property ('the Property') to A Ltd for one year retrospectively from April 2012, whilst A Ltd would provide the Property back to Mr. X as a free place of residence. Notwithstanding that the market rent of the property at that time was $50,000, the rent provided under the tenancy was $100,000 payable in arrears at the end of each month. The mortgage interest payable by Mr. X in respect of the Property was around $40,000 per month.

Required:

In respect of the quarters arrangement between A Ltd and Mr. X, advise:

(a) how Mr. X could benefit from the arrangement for tax purposes. (Note: No computation is required.) **(6 marks)**

(b) how Mr. X should be assessed to salaries tax in respect of the arrangement. (Note: Critically analyse the arrangement and discuss whether s.61 of the IRO is likely to be invoked by the IRD. **(9 marks)**

(Total = 15 marks)

HKICPA December 2011 (amended)

Dr. A

20 minutes

Dr. A operates a medical practice in his own name in Hong Kong. Recently, Dr. A is considering to carry on his medical practice through Company E. Company E is a corporation of which Dr. A and Mrs. A are the only shareholders and directors. It incurred a significant loss from share dealing in 1997, and has been left dormant since then.

Dr. A consults his accountant as to whether it is a good idea from a tax perspective.

Required:

Discuss the following issues in relation to Dr. A's idea of carrying on his medical practice through Company E:

(a) whether and, if so, how the change in mode of carrying on the medical practice can help Dr. A reduce his tax liabilities. **(6 marks)**

(b) what ethical considerations the accountant should be aware of in advising Dr. A on such a tax planning idea. **(5 marks)**

(Total = 11 marks)

HKICPA December 2012 (Amended)

Further reading

Suggested References

When studying this topic we suggest the following references:

Primary References

Advanced Taxation in Hong Kong, Pearson (Chapters 22 and 24)

Hong Kong Master Tax Guide, CCH Hong Kong Ltd (Chapter 13)

Hong Kong Taxation – Law & Practice, The Chinese University Press (Chapter 10)

Hong Kong Taxation and Tax Planning, Pilot Publishing Co Ltd (Chapters 13, 24, 34, 35 and 41)

Inland Revenue Ordinance (Part III, IV, VI & X)

DIPN 15 (Revised) (A) Limitation of Loss Relief (s.22B); (B) Leasing Arrangements (s.39E); (C) General Anti-avoidance Provision (s.61); (D) General Anti-avoidance Provision (s.61A); (E) Loss Companies (s.61B); (F) Ramsay Principle; (G) Penalty on Tax Avoidance Cases; (H) Guidelines on Lease Financing; (I) Advance Rulings

DIPN 24 (Revised) Profits Tax – Service Company 'Type II' Arrangements

DIPN 25 (Revised) Service Company 'Type I' Arrangements – Salaries Tax

DIPN 31 (Revised) Advance Rulings

DIPN 45 Profits Tax – Relief form Double Taxation due to Transfer Pricing or Profit Reallocation Adjustments

DIPN 46 Transfer Pricing Guidelines – Methodologies and Related Issues

DIPN 48 Advance Pricing Arrangement

Supplementary Reference

Hong Kong Tax Manual, CCH Hong Kong Ltd (Para 25 and 50)

chapter 10

Tax investigation and field audit

Topic list

1 **Tax investigations and case selection**
  1.1 Case selection
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  2.1 Initial interview
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Learning focus

The IRD has powers to investigate a taxpayer's affairs and carry out a field audit. Taxpayers subject to an investigation have rights as well as obligations. Tax representatives may also play an important role in managing tax investigations on behalf of taxpayers.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Describe the key aspects of the tax system in Hong Kong		
1.16	**Field audit and tax investigation**	2
1.16.01	Identify the essential issues concerning tax investigation and field audit	
1.16.02	Identify the efficient ways to lead a tax investigation to an early settlement	
1.16.03	Explain the settlement methods used by the IRD in the quantification process	
1.16.04	Explain and apply DIPN 11	
Tax planning		
2.41	**Offences and penalties**	3
2.41.01	Discuss the exposure to penalty action in tax planning	
2.41.02	Explain and apply DIPN 15	

1 Tax investigations and case selection

Topic highlights

A tax investigation or field audit generally aims at recovering tax undercharged in back years, deterring tax evasion and improving compliance.

In 1976 the IRD set up its Investigation Unit to deter tax evasion. In 1991 the IRD introduced field audits to encourage voluntary compliance by taxpayers through:

(a) ensuring improved compliance by taxpayers after being audited by the field audit teams;

(b) recovering back taxes lost from taxpayers' non-compliance;

(c) taking penal actions against non-compliance; and

(d) educating the public by establishing a 'moral multiplier effect' with the visible presence and deterrence of the field audit teams.

In the past, tax investigations were conducted by the Investigation Unit of the IRD while field audits were performed by the field audit teams, both under the supervision of the Deputy Commissioner (Operations). The Investigation Unit was primarily responsible for the in-depth investigations where tax evasion was suspected. On the other hand, a field audit was aimed at:

(a) non-lodgement of tax returns;

(b) failure to inform the Commissioner of the chargeability to tax;

(c) incorrect returns resulting from understatement of income and/or overstatement of deductions;

(d) failure to keep sufficient business records;

(e) other non-compliance offences; and

(f) over-aggressive tax planning.

As part of the IRD's regular reviews to streamline its structures and procedures, the Investigation Unit and Field Audit Group were merged in April 2000 to form the Field Audit and Investigation Unit in order to increase efficiency by eliminating duplicated efforts and encouraging information sharing. The Field Audit and Investigation Unit is under the management of the Assistant Commissioner of Unit 4 and is overseen by the Deputy Commissioner (Operations).

Field audits have been proven to be successful both in terms of tax recovered and improvement in taxpayers' records. Enlarged audit coverage is expected to continue in the future.

DIPN 11 outlines the elements of field audit and tax investigation and how a tax representative can assist his client in such circumstances.

DIPN 12 indicates that although the payers of certain income to anonymous recipients may agree to bear the tax on such payments, the payees are still obliged to make a return of such income for tax purposes.

1.1 Case selection

The IRD has adopted an Assess First Audit Later System since April 2001. Data in the returns are input into the system which then screens out the returns which meet the preset criteria for automated assessment. A certain percentage of these automated assessments are then selected based on additional criteria for audit and investigation by the assessing officers. Manual selection would also be carried out by the assessing officers.

Investigation or field audit is normally initiated by the IRD where characteristics or indications of non-compliance, such as the following, are present:

(a) the auditors' report in respect of the accounts of an incorporated business is heavily qualified;

(b) a business has an unreasonably low turnover or profit percentage (having regard to factors such as the nature of the business, its location and type of customers);

(c) persistent failure to lodge, or late lodgement of, tax returns;

(d) failure to keep proper business records; and

(e) failure to provide material information requested by an assessor.

Field audit cases may be selected:

(a) by the IRD officers by exercising their professional judgment and experience and knowledge of the trade or industry; or

(b) on a random basis as a means of promoting voluntary compliance.

Other investigation and field audit cases may be triggered off by information provided by the press, the police or informers.

The IRD has also established a system of a three-tier audit system ('Audit Trilogy'), whereby advanced information technology is used to assist assessing officers in conducting desk audits, field auditors in conducting field audits, and investigators in performing in-depth investigations.

The computer programme of the IRD is designed to provide an objective and efficient selection process to select desk audit cases. Both the 'random selection' and the 'risk-based selection' methods are used. The former method ensures that all returns have an equal chance of being selected, while the latter method is based on risk assessment. Risk-bearing items (e.g. claims for bad debt deductions) are assigned different weights and the score for each risk-bearing item is computed. Returns with high total scores will be selected for desk audit. It is anticipated that the risk factors and their assigned weights will not remain static.

If understatement or evasion is suspected during the course of desk audit, audit professionals then take the case for field audit. Serious cases requiring an in-depth examination are transferred to investigators for a full tax investigation.

2 Conducting a tax investigation or field audit

Topic highlights

The IRD will examine the financial records of the taxpayer when conducting a tax investigation or field audit. Stages of the investigation process include pre-audit notification, initial interview, field visit, examination of books and records and post audit meeting.

In conducting a tax investigation or field audit, the IRD will examine the records of the taxpayer and the financial affairs of the taxpayer and his or her close relatives so as to ascertain whether there is any tax undercharged.

In addition to information provided by the taxpayer, the IRD may contact third parties (e.g. customers, bankers, Land Registry, auditors, solicitors) to obtain additional information in respect of the financial affairs of the taxpayer.

Concerning the information that might be sought from the accountants or auditors of the taxpayer, there is a distinction between 'accounting papers' and 'advice papers' as elaborated by Mr Anthony Au-Yeung, the then Commissioner, in his address to the members of the then Hong Kong Society of Accountants ('HKSA') on 2 May 1991 as follows:

> *"Tax documents can be divided into two broad categories, accounting papers and advice papers. Accounting papers are what we understand to be traditional accounting records such as documents of original record, ledgers, journals, profit and loss accounts and balance*

sheets. Also included as accounting papers are papers prepared in connection with the inauguration, implementation and recording of transactions. These are essential documents that explain the background, framework and purpose of the transactions and as such they form an integral part of the basic fabric. As they are documents of record rather than documents of advice, full and free access to them is necessary.

Tax working papers serve to reconcile the information contained in the taxpayer's records with the information reported in the tax return. As they are fundamentally an extension of the taxpayer's own records they are considered to be accounting papers. Similarly, the permanent audit file maintained by the taxpayer's auditor, which serves to explain the basis of a taxpayer's organisation and operations, falls within the accounting papers category."

Advice papers are not, in a strict sense, accounting papers. Advice papers will include:

(a) advice given after completion of a transaction if that advice did not affect the recording of the transaction in the books of accounts or tax return;

(b) papers relating solely to transactions or arrangements that have not been, and are not intended to be implemented; and

(c) tax working papers which, in substance, express an accountant's opinion on matters contained in a tax return.

In the generality of cases, these papers will not be sought.

The IRD is of the view that legal privilege (i.e. the practice under common law that the information possessed by a legal practitioner in respect of his or her client is protected from disclosure to any third party without the client's consent) is founded on the protection of the client, not the legal practitioners, and will not cover communications in furtherance of crime and fraud.

The IRD has indicated that legal privilege does not apply to the accounting papers and advice papers as described above and advice papers can be sought:

(a) in tax avoidance cases with a sole or predominant purpose to obtain a tax benefit; or

(b) where crime and fraud are suspected.

A typical field audit case may involve the following procedures:

Step	IRD's actions
Pre audit notification	Issue invitation letter to the taxpayer.
Initial interview	Meet the taxpayer either at the IRD or the taxpayer's business premises at a time agreed by the taxpayer.
Field visit	Visit the taxpayer's business premises at a time agreed by the taxpayer.
Examination of books and records	Carry out audit work on books and records.
Post audit meeting	Discuss and agree on the basis of settlement.
Assessments or additional assessments	Raise assessments or additional assessments per agreed discrepancy or if no basis of settlement is agreed, raise estimated assessments or additional estimated assessments.
Penal actions	Prosecution through the courts or additional tax assessment by the Commissioner or a Deputy Commissioner.

The following is a general description of the activities of the IRD in conducting a field audit or a tax investigation.

2.1 Initial interview

During the initial interview with the IRD, the IRD will explain the objective of tax investigation or field audit to the taxpayer and provide him with a chance to consider co-operation and disclosure. For field audit cases, the initial interview will usually take place at the taxpayer's business premises which will allow the IRD to gain a thorough understanding of the business operations of the taxpayer and to detect whether tax evasion or avoidance is involved.

The IRD will usually seek information on:

(a) details of the day-to-day operations of the business (e.g. who, when, how);

(b) the accounting and bookkeeping procedures; and

(c) details of the personal affairs (e.g. general background, bank accounts, property, investments and other assets, family members, living style, sources of funds) of the taxpayer and associated persons (e.g. spouse, children).

Questions concerning the day-to-day operations of the business may include:

(a) what books of account have been kept;

(b) who is responsible for keeping the books of account;

(c) whether all the sales are recorded in the books of account;

(d) who is responsible for handling cash sales;

(e) whether receipts are issued for all sales;

(f) what payments are made in cash;

(g) whether there are receipts or documents for payments made; and

(h) how personal expenses are segregated from business expenses.

The IRD will request the taxpayer to verify his signature in the tax returns and to confirm the correctness of the returned profits. The taxpayer may request to check his own records before confirming the correctness of the returned profits.

The IRD will explain the penalty provisions, prosecution (including offer to compound) or additional tax (maximum 300% of tax undercharged or would have been undercharged if the failure has not been detected) to the taxpayer in the initial interview. The penal actions are to be exercised by the Commissioner or his Deputy. The IRD will also advise the taxpayer that the Commissioner will adopt a more lenient approach in voluntary disclosure cases and take into account the taxpayer's degree of co-operation and time span in considering the penal action.

After the initial interview, the IRD will send a copy of the meeting notes to the taxpayer for his review and confirmation.

As a token of co-operation, the taxpayer may at the initial interview estimate the amount of under-statement and make a voluntary offer to place a deposit with the IRD sufficient to cover the estimated liability. Such action will be considered as a mitigating factor when penalties are assessed.

2.2 Field visit and examination of books and records

After collecting information in respect of the business operations and details of accounting records of the business, the IRD will carry out basic audit work (e.g. verification of postings, examination of year-end adjustments). They will then identify the records for a more detailed audit.

In examining the books and records of the taxpayer, the IRD will perform audit work such as:

(a) vouching;

(b) casting;

(c) ratio analysis; and

(d) projection of profit/income.

The IRD may also:

(a) select samples of sales and purchases to work out a gross profit ratio;

(b) sum up deposits in bank accounts (personal and business) to verify the annual sales figure;

(c) project annual profits with average gross profit ratio;

(d) verify collection of trade debts;

(e) trace sample transactions to books of accounts;

(f) examine entries in current accounts; or

(g) examine vouchers of expenses to ascertain deductibility and to identify double or false claims.

2.3 Basis of settlement

The IRD may use the following direct and indirect methods (which are non-exhaustive and not mutually exclusive) to quantify the amount of tax undercharged:

(a) direct quantification, if the taxpayer's books and records are reliable;

(b) Assets Betterment Statement ('ABS') or net worth method;

(c) bank deposits method;

(d) business economics (percentage computation) method; and

(e) projection method.

2.3.1 Examination of books and accounts

Since the introduction of s.51C for keeping proper books and records, the IRD would usually inspect the books and records kept by the taxpayers. If these have been kept properly, the understatement or transactions not reflected in the taxpayer's tax returns would be easily ascertained. As long as the books and records are confirmed not to have been manipulated, the tax representatives should prepare revised accounts for the taxpayers. In addition, the tax representatives should also prepare analysis of the Drawings Account of the taxpayer, or, in the case of a company director, of his Current Account and Loan Accounts, if any. Details should also be provided in respect of each Loan, and Debtor or Creditor Account in the name of a member of the taxpayer's family. The extent of scrutiny undertaken will depend on the circumstances of the case.

Where proper books and records were not kept by the taxpayer, the IRD will resort to other indirect methods and the most commonly used is the ABS method. The method is detailed in DIPN 11, paragraphs 62 to 71 as follows:

2.3.2 Assets Betterment Statement (Net worth) method

An ABS is generally the most comprehensive indirect means of quantifying an understatement of profits. The method may also be applied to quantify understated employment income in salaries tax cases. An ABS discloses the correct taxable profits or income of a person by adding to the person's yearly asset increase (i.e. the excess of net assets in any one year over that of the previous year) all expenditures of a non-allowable nature, and deducting from it receipts which are of a capital nature or otherwise not assessable, to arrive at the betterment profits. Adjustments are also made if necessary in respect of any applicable depreciation allowances or balancing charges. This can be summarised simply by the following formula:

Formula to learn

Betterment profits = Increase in net assets + Disallowable expenditures – Non-taxable receipts

The preparation of an ABS entails making a detailed analysis of the taxpayer's Drawings Account or company Current Account, Loan Accounts and bank accounts (or accounts held with similar institutions) which show deposits or withdrawals of money. The accounts of the taxpayer's immediate family members, such as his spouse and dependent children, should also be reviewed and analysed if appropriate. The analysis should, of course, cover every item and be in chronological order. The closing date for each year of the ABS should correspond with the business accounting date. The results of the analysis may be categorised as follows:

Lodgements

(a) Transfers with a note of origin (e.g. from another bank account);

(b) Capital receipts with a brief note of origin (e.g. sale of property);

(c) Income receipts with a note of source;

(d) Other identified receipts with a brief description;

(e) Unidentified receipts by specific cheques; and

(f) Unidentified receipts by cash.

Withdrawals

(a) Transfers with a note of destination;

(b) Capital payments with a brief description (e.g. purchase of shares);

(c) Personal payments with a note of nature (e.g. school fees, household expenditure);

(d) Other identified payments with a brief description;

(e) Unidentified payments by specific cheques; and

(f) Unidentified payments by cash.

During the course of the initial analysis referred to above, it may not be possible to immediately identify all the items which may be numerous. However, many of these will be cleared as further accounts are analysed and further information is obtained.

Concurrently with the initial analysis, it is useful to prepare three schedules:

(a) An annual Assets Statement which can be completed as the assets emerge;

(b) A Statement of Personal and Living Expenditure in which identified items can be entered as they emerge; and

(c) A Statement of Income, to be completed as each item is identified.

The Asset Statement of a sole proprietor should include all his business and private assets and liabilities. In the case of a partner, an Asset Statement would contain the balances of his capital and loan accounts in respect of the partnership. For a shareholder, an Asset Statement would include shares held by the shareholder and balances of his current and loan accounts. A specimen format of an ABS can be found in DIPN 11, Appendix A; and a simplified format is shown below:

Assets Betterment Statement

		At the beginning of the accounting year	*At the end of the accounting year*
		$	$
Assets:	Business	X	X
	Private	X	X
Total assets		A1	A2
Liabilities:	Business	X	X
	Private	X	X
Total liabilities		L1	L2
Net assets (A – L)		NA1	NA2
Increase in net assets (NA2 – NA1)			NAI
Add:	Disallowable items in the accounts		X
	Private expenses and gifts made		X
	Living expenses (to be justified from circumstances)		X
	Taxes paid		X
	Loss on sale of shares / properties		X
	Remittance outwards		X
	Unidentified withdrawals		X
			X
Less:	Depreciation allowances		(X)
	Profits on sale of share / properties		(X)
	Non-business income		(X)
	Gifts received		(X)
	Remittance inwards		(X)
	Distributions from partnership business		(X)
Betterment profits			B
Less:	Returned profits		(R)
Discrepancy (additional profits)			D

In preparing the ABS, the tax representative should also consider the following questions:

(a) Has everything possible been done to trace the origin of all money which has been lodged or has appeared in banks or elsewhere?

(b) Has everything possible been done to find the destination or purpose of all money which has been withdrawn from banks or elsewhere?

(c) Have all assets been identified from which income has been received?

(d) Have the full cost and the means of payment of each asset been ascertained?

(e) Has the application of the disposal proceeds of each asset sold been ascertained?

(f) Has the application of all known income been ascertained?

(g) Has all of income from assets which should have been productive of income been identified?

(h) Have all items of expenditure normally paid by cheque or through bank accounts (e.g. tax, life assurance, school fees, electricity, gas and rates) been traced?

Addressing the above issues may further disclose unidentified items, or lead to other accounts being revealed, and accordingly necessitate revision of the draft ABS. The tax representative should also consider whether amounts brought out by the analysis accurately reflect personal and household expenditures. Any untraced items mentioned above would have to be brought into account, as would any exceptional item of expenditure (e.g. holidays, doctors, bills and gifts).

When reviewing the adequacy of private expenditures shown on the ABS, it is pertinent to consider the following points:

(a) What domestic expenditure has normally been required?

(b) Are there regular cheques or other bank payments (e.g. by direct debit) for the relevant categories of domestic expenditure, or have some purchases been paid in cash?

(c) What other domestic or personal expenditure has been paid in cash?

(d) Do the ABS figures adequately reflect the cash expenditure on the items in question? If not, the deficiency requires explanation.

Finally, it is necessary to consider the character of the remaining unidentified lodgements and unidentified withdrawals. This involves consideration of factors such as the explanations provided by the taxpayer, the nature of the taxpayer's business and the method of accounting on which the original accounts were based. A decision must be taken on the basis of all available material. However, in the absence of evidence to the contrary, it should be presumed that unidentified withdrawals were not in respect of deductible expenditure and they therefore have to be included as additions in computing the betterment profits. For unidentified lodgements, it cannot be accepted that they were of a capital nature or otherwise non-taxable and accordingly cannot qualify as deductions in computing the betterment profits unless there is supporting evidence. It should be kept in mind that the BOR has pointed out that the assertion of a fact is not an evidence (*D20/89*). The status of the ABS has been explained by the BOR in *D28/88*. The duty is on the taxpayer to produce all documents he considered relevant to support his claim (*D6/92*).

When the matters regarding the lodgements and expenditures referred above have been resolved, the representative should make appropriate final amendments to the draft ABS. The overall result can then be examined in the light of probabilities concerning, for example, known profit trends.

Other indirect methods may be used when an ABS cannot be satisfactorily completed. Other indirect methods are not mutually exclusive and may also be used as a means to gauge the accuracy of an ABS where completion of one has been possible.

Example 1

Mr. Yip, the sole proprietor of a fast food shop, has recently received a query from the IRD regarding his understatement of profits. You have been instructed by Mr. Yip to negotiate with the IRD, and you have decided to prepare an ABS for submission to the IRD.

Required:

Describe what the ABS method is; and list the initial information and records you would need to prepare an ABS.

Solution

The ABS method is one of the indirect methods of calculating profits. It is the most comprehensive method used by the IRD to quantify the understatement by a taxpayer being investigated. The ABS method is commonly used when direct quantification is not possible due to the absence of books and records or when the taxpayer's books and records, though available, are incomplete, inadequate or unreliable.

The ABS method is also known as the Net Worth method. The function of an ABS is to compute the correct taxable profits or income of a person by adding to the person and their spouse's yearly asset increase (the excess of net assets in any one year over that of the previous year) all expenditures of a non-allowable nature, and deducting from it receipts that are of a capital nature or otherwise not assessable to arrive at the betterment profits. Adjustments are also made where necessary for any applicable depreciation allowances or balancing charges. This can be summarised by the simple formula: Betterment profits = Increase in net assets + Disallowable expenditures – Non-taxable receipts. In theory, betterment profits equal correct taxable profits. An excess of the betterment profits over profits returned or assessed implies an understatement in the amount of the discrepancy.

The following initial information and records are needed to prepare an ABS:

(a) A list of the business books (if any).

(b) A list of the bank accounts in operation, both business and personal.

(c) A list of property, investments and other assets, including such items acquired in the name of other persons.

(d) A list of bank accounts which have been closed and particulars of property etc, sold during the relevant period.

(e) A list of liabilities.

(f) A list of the assets and liabilities on hand at the beginning of the relevant period.

(g) A copy of the tax returns and assessments raised.

(h) A list of the name of all family members.

(i) A list of debtors and creditors at the beginning and end of the period under investigation.

HKICPA September 2001 (Amended)

Self-test question 1

Background Information:

Nature of business:	Insurance agent
Reason for selection:	Purchase of property with unidentified source of income
Information provided by the taxpayer in the initial interview:	The taxpayer is married with no child (his wife is not working). Business is conducted by the taxpayer and two assistants (the taxpayer's parents). The taxpayer does not have sufficient accounting knowledge to keep proper books of account. Total assets were $200,000 at the start of business (with no private assets or outstanding liability). No tax has been paid after the election for personal assessment. Total assets now include: • bank deposits $100,000 • residential property $5,000,000 (cost) • net business assets $300,000 Total liabilities now include: • outstanding mortgage loan $2,000,000 Living expenses: $120,000 per annum Other expenses paid: • legal costs, stamp duty, etc. $200,000 • mortgage loan interest $800,000

Examination of books and records:	Incomplete record of commission income. No record of business expenses. Total returned profits for the period: $600,000.
Information collected from banks, etc:	Bank deposits (other than those disclosed by the taxpayer in the initial interview): $1,000,000 (in joint name with the taxpayer's wife). Total interest income during the period of investigation: $400,000. Listed securities: $3,000,000 (acquired at a cost of $2,000,000).
Basis of settlement:	Assets Betterment Statement
Penal actions:	Additional tax assessments and penalty tax under s.82A.

Required:

Assume there are five years covered by the investigation, prepare a top and tail ABS as follows:

Assets Betterment Statement for the period from (Date 1) to (Date 2)

		At the start of business (Date 1)	*Latest accounting year end date (Date 2)*
		$	$
Assets:	Business		
	Private		
Total assets			
Liabilities:	Business		
	Private		
Total liabilities			
Net assets			
Increase in net assets			
Add:	Disallowable expenditures		
Less:	Non-taxable receipts		
Betterment profits			
Less:	Returned profits		
Discrepancy (additional profits)			

(The answer is at the end of the chapter)

2.3.3 Bank deposit method

When most of the taxpayer's income is deposited into bank accounts, the bank deposit method can be used to ascertain the gross receipts and under-reported profits. The total bank deposits plus unbanked deposits for the taxpayer's private use represent the total net sales of the business. An 'average' or 'representative' gross profit ratio is then applied to the total net sales to quantify the understatement of gross profits. A specimen format of the bank deposit method can be found in DIPN 11, Appendix B; and a simplified format is as follows:

Bank Deposit Method for the Period

		$
Total deposits		X
Less:	Interbank transfer or deposits	(X)
	Returned cheques	(X)
	Sales of capital assets	(X)
	Rental income	(X)
	Other non-business deposits	(X)
Adjusted total deposits		X
Add:	Unbanked deposits for expenses (estimated)	X
	Debtor's closing balance	X
Less:	Debtor's opening balance	(X)
Business turnover		B
Less:	Reported turnover	(R)
Discrepancy (additional profits)		D

2.3.4 Business economics (percentage computation) method

This method can be used to determine the cost of sales, expenses, gross profits or net profits. Percentages (or ratios) are applied to particular known amounts to compute figures required to determine the taxpayer's assessable profits, e.g. the net profit ratio is applied to sales to determine the net profit. The percentages or ratios may be derived from:

(a) the taxpayer's accounts or records in respect of other periods; and

(b) business operations similar to those of the taxpayer.

Example 2

Background Information:

Nature of business:	Toys retailer as a sole proprietor
Reason for selection:	Letter from an anonymous informer
Information provided by the taxpayer in the initial interview:	The taxpayer is single. He has no bank account. Goods are bought from wholesalers on credit (30 – 60 days). All sales are made in cash, usually at a mark-up of 20% on cost. Stock on hand is about $250,000. Operating expenses are about $25,000 per month. No tax return has been filed. The taxpayer closes its accounts on 30 April every year.
Examination of books and records:	Full records of purchases from wholesalers, about $500,000 per month.
Information collected from banks, etc:	N/A
Basis of settlement:	Profit percentage method
Penal actions:	Compound penalty under s.80(5) for failure to inform chargeability under s.51(2).

Required:

Assuming the taxpayer only started operations on 1 March 2011, compute the tax undercharged for the years of assessment 2011/12 and 2012/13 using the percentage computation method.

Solution

Year of assessment 2011/12

	$
Purchases	500,000
Less: closing stock	(250,000)
Cost of sales	250,000
Gross profit (20%)	50,000
Less: operating expenses	(25,000)
Net profit	25,000
Tax thereon at 15%	3,750

Year of assessment 2012/13

	$
Opening stock	250,000
Purchases	6,000,000
	6,250,000
Less: closing stock	(250,000)
Cost of sales	6,000,000
Gross profit (20%)	1,200,000
Less: operating expenses	(300,000)
Net profit	900,000
Tax thereon at 15%	135,000

Since personal allowance and tax reduction is only applicable to salaries tax or tax under personal assessment for the years of assessment 2011/12 and in 2012/13, if the taxpayer does not have other income, it would be tax beneficial for him to elect for personal assessment to take advantage of the personal allowance ($120,000).

2.3.5 Projection method

Where the taxpayer's assessable profits have been correctly determined for a particular year of assessment, the relevant figure (e.g. sales, expenses) may be used to extrapolate to other years to estimate the assessable profits.

Example 3 (Adapted from DIPN 11, Example 3)

Omitted sales deposited in the private bank account of a director were added back to the profit of the audit year. Omitted sales in other years were obtained by extrapolating from the percentage of sales omitted in the audit year.

Example 4 (Adapted from DIPN 11, Example 4)

Salaries payable to relatives of the director and entertainment expenses were charged in the accounts of the audit year. No services had been provided by the relatives and the accrued salaries were never paid; while the entertainment expenses were the private expenses of the director. The proportion of salaries and entertainment expenses, which had been denied deductions, was computed and the results were extrapolated to other years since sums of the same nature were similarly charged in the accounts.

2.4 Settlement interview

When the IRD or the taxpayer (or his tax representative) has formulated a basis of settlement, a meeting will be held to discuss the validity of such basis. The taxpayer is allowed to examine the finding of the IRD and to provide feedback on the settlement basis. Final settlement will be signed by the taxpayer to confirm his acceptance. The IRD will remind the taxpayer that the Commissioner or his Deputy will consider penal actions after the case is settled.

2.5 Assessments or additional assessments

During the course of field audit, the IRD may issue protective assessments for certain years of assessment in order to protect the IRD from a time-bar situation. Taxpayers have the right to object against such assessments in the same manner as in normal tax assessments situation. The IRD may then arrange to holdover a certain sum of money conditionally (the taxpayer has to provide a banker's undertaking or purchase a Tax Reserve Certificate) or unconditionally, and may demand the balance to be paid, as the case may be.

On closure of the field audit, if there is an agreed settlement basis, the IRD will issue assessments or additional assessments based on the agreed discrepancy (to be spread over a number of years of assessment as mutually agreed).

If no basis of settlement can be reached between the taxpayer and the IRD, the IRD will raise estimated assessments on the taxpayer. The taxpayer's objection will then be submitted to the Commissioner for determination. Further appeal will be submitted to the BOR. Penal actions will be taken after the case is determined by the Commissioner or the BOR.

2.6 Penal actions

The Commissioner will take into account the following factors while considering penal actions:

(a) degree of co-operation;

(b) extent of voluntary disclosure;

(c) time span of non-compliance; and

(d) other aggravating or mitigating factors.

Penal actions include:

(a) prosecution under s.82(1) for wilful tax evasion;

(b) prosecution under s.80(2) for incorrect returns or failure to inform chargeability to tax without a reasonable excuse;

(c) prosecution under s.80(1) for other offences (e.g. failure to notify change of address);

(d) prosecution under s.80(1A) for failure to keep proper business records; and

(e) assessments to additional tax raised by the Commissioner or a Deputy Commissioner personally under s.82A (provided no prosecution has been initiated against the taxpayer for the same offence).

The Commissioner may compound the offence before judgment from the Court in a prosecution case. Taxpayers (or their representatives) may make an explicit request to the Commissioner to compound offences.

The IRD indicates in its penalty policy (see **http://www.ird.gov.hk/eng/pol/ppo.htm**) that offences that do not involve any wilful intent to evade tax are generally dealt with administratively by the imposition of monetary penalties in the form of additional tax under s.82A. The IRD also indicates that the following factors will be considered in an additional tax assessment under s.82A:

Factors	Mitigating	Aggravating
Background of the taxpayer and sophistication of the business	• Illiterate or has a low standard of education • Simple and unsophisticated business	• Sophisticated taxpayers • Established and sophisticated business
Attitude of the taxpayer	• Genuine concern, serious, responsive and co-operative • Sincere and willing to compromise • Ready to accept the discrepancy when quantified	• Undue delay or obstruction to the progress of audit and investigation • Passive and unwilling to compromise • Evasive and belated acceptance of the discrepancy quantified
Time span	• Casual or one-off understatement	• Multiple and repeated evasion acts over a consecutive number of years (e.g. persistent default in rendering returns and making of incorrect returns when pressed with estimated assessments)
Scale of business and quantum of the understatements	• Relatively small cases • Accepted discrepancy includes substantial contentious items	• Cases with substantial quantum of understatement having regard to the operating scale of the business • Discrepancy consisting of specific fictitious items with cover-up tactics

The IRD states that the penalty may be scaled upwards or downwards to a maximum of 25% in the generality of cases, depending on the facts particular to each case.

In addition to the above, the IRD has in recent years actively imposed the penalty under s.51C where the taxpayers have been found not to be keeping proper books and records.

Example 5

Mr Lee and his wife are aged retirees. Mr Lee has obtained a business registration for a sole proprietorship grocery business called 'Wing Kee'. For years, the profits of Wing Kee as reported in Mr Lee's tax returns were below the personal allowance due to Mr and Mrs Lee. As a result, Mr Lee was not required to pay any tax for the profits made. In a recent field audit, the officers of the IRD found that Wing Kee had actually ceased business for years. The income of Wing Kee as reported in Mr Lee's tax returns were in respect of some design fees derived by his daughter, Janny. Janny is an interior designer and she is in full time employment. She also contracted with other interior design companies to provide part time services to them for design fees. It was so arranged that the design fees were credited directly by the payers to the bank account of Wing Kee. The officers of IRD also found that Janny did not report this income in her own tax returns.

Janny is exposed to the following penal actions provided under the IRO:

Janny made use of her father's sole proprietorship business to receive her part time remunerations for the purpose of reducing her own tax liabilities. Janny omitted to report the part time remunerations in her own tax returns.

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If Janny is found to have no reasonable excuse for such omission, she may commit an offence under s.80(2)(a), which will result in a fine at level 3 ($10,000) plus treble the amount of tax undercharged. The Commissioner may compound any offence under s.80(5) and may before judgment stay or compound any proceedings thereunder.

Alternatively, the IRD may challenge that Janny had wilfully evaded tax and take prosecution action against Janny for her offence under:

(a) Section 82(1)(a) – omits from a return made under the IRO any sum which should be included.

(b) Section 82(1)(d) – signs any statement or return without reasonable grounds for believing the same to be true.

(c) Section 82(1)(g) – makes use of any fraud, art or contrivance.

On summary conviction, the maximum penalty for each charge is a fine at level 3 ($10,000) plus treble the amount of tax undercharged and imprisonment for six months under s.82(1A)(a). On indictment, the maximum penalty for each charge is three years' imprisonment and a fine at level 5 ($50,000) plus a further fine of treble the amount of tax undercharged under s.82(1A)(b). The Commissioner may also compound the offences under s.82(2) and may before judgment stay or compound any proceedings thereunder.

Instead of prosecuting Janny, the Commissioner or a Deputy Commissioner may assess Janny to a penalty tax under s.82A, the maximum amount of which is treble the amount of tax undercharged.

HKICPA February 2009 (Amended)

Self-test question 2

Mr Lee is the sole proprietor of a grocery business called 'Lee Kee'. For years, the profits of Lee Kee as reported in Mr Lee's tax returns were below his entitled personal allowances. In a recent field audit, the officers from the IRD found that Mr Lee had not included one category of Lee Kee's sales in his returns submitted to the IRD. The omission was found for the years of assessment 2009/10 to 2011/12. The omitted sales were in excess of $1 million for each year and represented about one-fifth of Lee Kee's total sales.

Mr Lee told the IRD officers that he was illiterate and relied on his bookkeeper for all the accounting and tax matters. He claimed to have no knowledge of the omission and volunteered to pay tax on the omitted sales. His bookkeeper explained that the omission was an oversight. Subsequent to the field visit, the IRD officers found by their own efforts that all the sales proceeds in respect of that omitted category of sales were deposited into the personal savings bank account which was held in the name of the bookkeeper in trust for Mr Lee.

Required:

Evaluate Mr Lee's and the bookkeeper's exposure to the penal actions provided under the IRO in connection with this investigation case.

HKICPA March 2000 (Amended)
(The answer is at the end of the chapter)

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3 Taxpayers' attitudes towards a tax investigation or field audit

Topic highlights

Taxpayers are advised to adopt a positive attitude (co-operative and realistic) to minimise the time and effort in agreeing a settlement with the IRD.

Prolonged investigation may cause:

(a) disruption of business administration;

(b) family distress;

(c) loss of reputation;

(d) more severe penalties; and

(e) increased professional charges.

It should be noted that the degree of co-operation of the taxpayer will be taken into account by the IRD when considering penal actions after the investigation is settled.

To expedite an early settlement with the IRD, the taxpayer should:

(a) seek professional advice;

(b) identify the possible causes of the investigation or field audit;

(c) identify the process and consequences of the investigation or field audit;

(d) review business records and personal financial affairs;

(e) identify problem areas;

(f) prepare for the initial interview with the IRD with the assistance from a professional tax advisor;

(g) show willingness to co-operate with the IRD in the initial interview;

(h) ensure that all accounting records, supporting vouchers and bank statements are ready for inspection during the field visit of the IRD;

(i) take the initiative to offer information to the professional tax advisor for submission to the IRD;

(j) respond promptly to the IRD's enquiries;

(k) evaluate settlement proposals suggested by the IRD or the professional tax advisor;

(l) propose a basis of settlement to the IRD;

(m) conduct negotiations with the IRD with the assistance of the professional tax advisor; and

(n) seek early compromise with the IRD with the assistance of the professional tax advisor.

The IRD often encourages the taxpayer or the tax representative to:

(a) disclose information and submit documents voluntarily;

(b) provide audit working papers to assist reconciliation of figures;

(c) explain the basis of the profits tax computations;

(d) suggest a proper approach or process to carry out the audit examination;

(e) propose a reasonably concrete basis of settlement voluntarily; and

(f) respond constructively to the IRD's proposed basis of settlement.

4 Tax representatives' role in a tax investigation or field audit

Topic highlights

Tax representatives may perform a specific role in a tax investigation or field audit which includes protecting the interests of the client and negotiating with the IRD for settlement. However, tax representatives must act within the legal and professional requirements.

Tax representatives may:

(a) provide professional advice on technical and procedural issues;

(b) protect the interest of the client;

(c) conduct preliminary review of the taxpayer's business and personal financial records;

(d) negotiate with the IRD on the conduct of the investigation;

(e) accompany the taxpayer to attend interviews with the IRD;

(f) prepare replies to enquiries of the IRD;

(g) prepare proposals for settlement with the IRD;

(h) negotiate with the IRD to resolve areas of contention;

(i) identify reasons for understatement of profits;

(j) identify mitigating circumstances for reduced penalty; and

(k) help improve the taxpayer's future compliance.

At present, there is no particular requirement (e.g. qualification, experience) for a person to act as a tax representative of another person.

4.1 Legal and professional requirements

It should be noted that pursuant to s.80(4), 'any person who aids, abets or incites another person to commit an offence under s.80 shall be deemed to have committed the same offence and to be liable to the same penalty'. Similarly, pursuant to s.82(1), 'any person who wilfully with intent to evade or to assist any other person to evade tax' shall be guilty of an offence. The tax representative is therefore exposed to the same penalty as that of the taxpayer if he fails to maintain professional ethics in advising his or her client.

In Hong Kong, no tax representative has yet been prosecuted under s.80(4) or s.82(1).

In the UK, there was a case *R v. Charlton and others* [(1996) STC 1418], in which an unqualified accountant, a barrister and two chartered accountants were convicted and imprisoned for conspiracy to cheat the public revenue.

In 'A Report of the Director of Audit on the Results of Value for Money Audits', the Director of Audit found that there were unqualified audit reports for more than half of the cases that revealed understated sales, overstated purchases or understated closing stock. For qualified audit reports, over 90% of the cases were previously qualified by the auditors. According to the ethics statement issued by the then HKSA at that time, the auditors should decline to continue the engagement if there were obstacles in performing their duties. In this regard, the Director of Audit has made suggestions to the Commissioner that legal actions should be taken against company auditors who had failed to detect tax evasions. Such comments were criticised by the accounting practitioners and the HKSA as detecting irregularities was not the primary role of an auditor. Nevertheless, the IRD has responded to the Director of Audit that it will consider initiating legal action against auditors (or tax representatives) in extreme cases.

Any member of the Institute who acts as tax representative of a client in a tax investigation or field audit should observe the ethical guidelines provided in the professional ethics statements issued by the Institute.

Example 6

Sam, a tax partner of a Hong Kong professional firm, has been instructed by Mary, his new client to negotiate with the IRD regarding her understatement of profits. Mary has told Sam in confidence that she in fact earned more than twice the profits she reported in her tax returns.

Required:

Advise how Sam should respond to Mary's instructions.

Solution

Sam should refer to the Institute's Code of Ethics for Professional Accountants for guidance (refer to chapter 11, section 1.3 for details). Sam owes the duty of confidence to Mary, his client. However, this duty can be qualified by Mary's conduct indicating that she has been guilty of taxation fraud or negligence. Sam should urge Mary, in her own interest, to make a full disclosure. He should impress on her the seriousness of her offences and the possible consequence (including criminal prosecution and the possibility of imprisonment upon conviction). Sam should advise Mary to make a complete disclosure to the IRD without delay. If Mary refuses to do so, Sam should inform her that he can no longer act for her in matters of taxation. It will be necessary for Sam to inform the IRD that he must dissociate himself from the returns or other information involved for the years in question and that he has ceased to act for Mary. To protect his own interests, Sam should keep a record of his advice to Mary.

However, Sam is under no legal duty to make any disclosure to the IRD of Mary's true profits. It would be improper for him to do so without first obtaining Mary's consent unless the IRD invokes s.51(4), requiring him to furnish information; or s.51B, to obtain a search warrant for the purpose of getting such information.

HKICPA September 2001 (Amended)

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5 Importance of business records

Topic highlights

Sufficient business records can be used to:

(a) satisfy legal obligations (e.g. s.51C);

(b) substantiate the returned profits of the taxpayer in a tax investigation or field audit; and

(c) provide information to management for better control of the business.

Section 51C specifies what business records are required to be kept by taxpayers. To encourage compliance by taxpayers, s.80(1A) imposes a penalty for failure to keep business records at a fine at level 6 (i.e. $100,000).

Business records required to be kept under s.51C are:

(a) books of account recording receipts and payments, or income and expenditure; and

(b) vouchers, bank statements, invoices, receipts, and such other documents as are necessary to verify the entries in the books of account.

Without limiting these general record keeping requirements, other records required to be kept and retained include:

(a) a record of the assets and liabilities of the person in relation to that trade, profession or business;

(b) a record of all entries from day to day of all sums of money received and expended by the person in relation to that trade, profession or business, and the matters in respect of which the receipt and expenditure take place;

(c) where that trade, profession or business involves dealing in goods:

   (i) a record of all goods purchased, and of all goods sold in the carrying on of that trade, profession or business (except certain cash retail trading) showing the goods, and the sellers and buyers in sufficient detail to enable the Commissioner to readily verify the quantities and values of the goods and the identities of the sellers and buyers; and all invoices relating thereto; and

   (ii) statements (including quantities and values) of trading stock held by the person at the end of each year of assessment, or at the account closing date, if other than 31 March; and all records of stocktakings from which any such statement of trading stock has been prepared; and

(d) where that trade, profession or business involves the provision of services, records of the services provided in sufficient detail to enable the Commissioner to readily verify the entries referred to in paragraph (b).

The above records should be kept in either English or Chinese for at least seven years after the completion of the transactions, acts or operations to which they relate (s.51C(1)). With regard to business records kept in electronic format, the IRD has issued a leaflet entitled '**Admissibility of Business Records Kept in Electronic Form for Tax Purposes**' in July 2002. The IRD indicates that keeping images of the original documents in electronic format are acceptable as an alternative to the keeping of the original documents themselves. Books and account and source documents kept in the electronic form are acceptable to the IRD provided the requirements set out in s.8 of the Electronic Transactions Ordinance ('ETO') are satisfied.

Section 8 of the ETO provides that where a rule of law requires certain information to be retained, whether in writing or otherwise, the requirement is satisfied by retaining electronic records, if:

(a) the information contained in the electronic record remains accessible so as to be usable for subsequent reference;

(b) the relevant electronic record is retained in the format in which it was originally generated, sent or received, or in a format which can be demonstrated to present accurately the information originally generated, sent or received; and

(c) the information which enables the identification of the original destination of the electronic record and the date and time when it was sent or received, is retained.

See the IRD website at **http://www.ird.gov.hk/index.htm** for details.

If the taxpayer is an owner of a property situated in Hong Kong, records of the consideration, in money or money's worth, payable or deemed to be payable to him, to his order or for his benefit in respect of the right to use that land or buildings or land and buildings to enable the assessable value of that land or buildings or land and buildings to be readily ascertained; must be kept (s.51D).

The rent records should also be kept in English or Chinese for at least seven years after the completion of the transactions, acts or operations to which they relate. Pursuant to s.80(1)(c), penalty for failure to keep proper rent records required under s.51D(1) is a fine at level 3 (i.e. $10,000).

Pursuant to s.51D(2), business and rent records are not required to be preserved if:

(a) the Commissioner directs that they need not be preserved; or

(b) they relate to a corporation that has been dissolved.

5.1 Guidelines on business records

The IRD has also issued guidelines on business records as follows:

Business records	Guidance from the IRD
Banking records	Maintaining separate bank accounts for business and personal purposes is recommended. Business bank account records which should be kept are: • cheque butts recording dates of payments; names of payees; details of goods or services purchased or accounts being paid; and amounts of cheques; • bank deposit slips; • bank statements.
Income records	Income records may include: • cash register tapes; • receipt books; • numbered invoices; • record book of cash sales transactions; • record book of stock taken for own use; • credit notes for returned goods.
Records of assets	Records must be kept to verify all expenditure relating to assets such as machinery and plant, land and buildings etc. Records of assets should include: • copies of purchase and sale contracts; • market valuations (for items acquired or disposed of other than by purchase or sale); • statements of account, invoices and/or receipts for services rendered (e.g. legal services); • records of agent's commissions and broker's fees; • records of stamp duty; • records of any expenditure incurred in improving the asset.
Records of debtors and creditors	If it is appropriate to take into account debtors and creditors in calculating the assessable profits of a business, the records of the business should include the details of debtors and creditors at the end of each accounting period. Records in relation to debtors should include: • debtors' (i.e. customers' or clients') names; • amount owed by each debtor; • total amount owed by all debtors; • length of time each debt has been outstanding; • when each debt is expected to be paid; • what steps have been taken to recoup each debt.

Business records	Guidance from the IRD
	Records in relation to creditors should include: • suppliers' names; • amount owed to each supplier; • total amount owed to all suppliers.
Records of depreciation allowances	Records of depreciation allowances that have been claimed as deductions should be kept to enable calculation of entitlement to depreciation allowances in subsequent years.
Records of purchases and expenses	Records must be kept to verify all business purchases and expenses. Such records may consist of: • cheque butts; • receipts for payments; • credit card dockets or statements; • invoices received; • petty cash vouchers and receipts for small purchases; • record book of daily expenses.
Records of trading stock	Records must be kept showing the quantity and value of trading stock held at the end of each accounting period. Trading stock is anything produced, manufactured, acquired or purchased for the purposes of manufacture, sale or exchange by the business. Goods may be treated as trading stock even though they are not in the actual possession of the business (e.g. stock held by an agent, goods in transit). A stocktake is often involved in ascertaining the quantity and value of trading stock held at the end of an accounting period. Documentary evidence of a stocktake should be compiled and kept with other business records. A list should be made describing: • each article of stock on hand (including raw materials and work in progress); • the value of the stock; • who did the stocktake; • how the stocktake was done; • the date of the stocktake; and • the basis of valuation.

Although the above guidelines do not have any binding force on the taxpayers, keeping the above records will certainly help taxpayers discharge the statutory requirements imposed under s.51C.

Self-test question 3

Your friend, Peter, told you that he has not reported the rebates from customers in his tax returns for the past five years. Although he now wants to report this income to the IRD, he has not kept proper books and records.

Required:

(a) Discuss how the IRD might know of the existence of this income.

(b) Explain how the IRD could quantify the assessable amounts.

(c) State the consequences of not reporting this income in the tax returns.

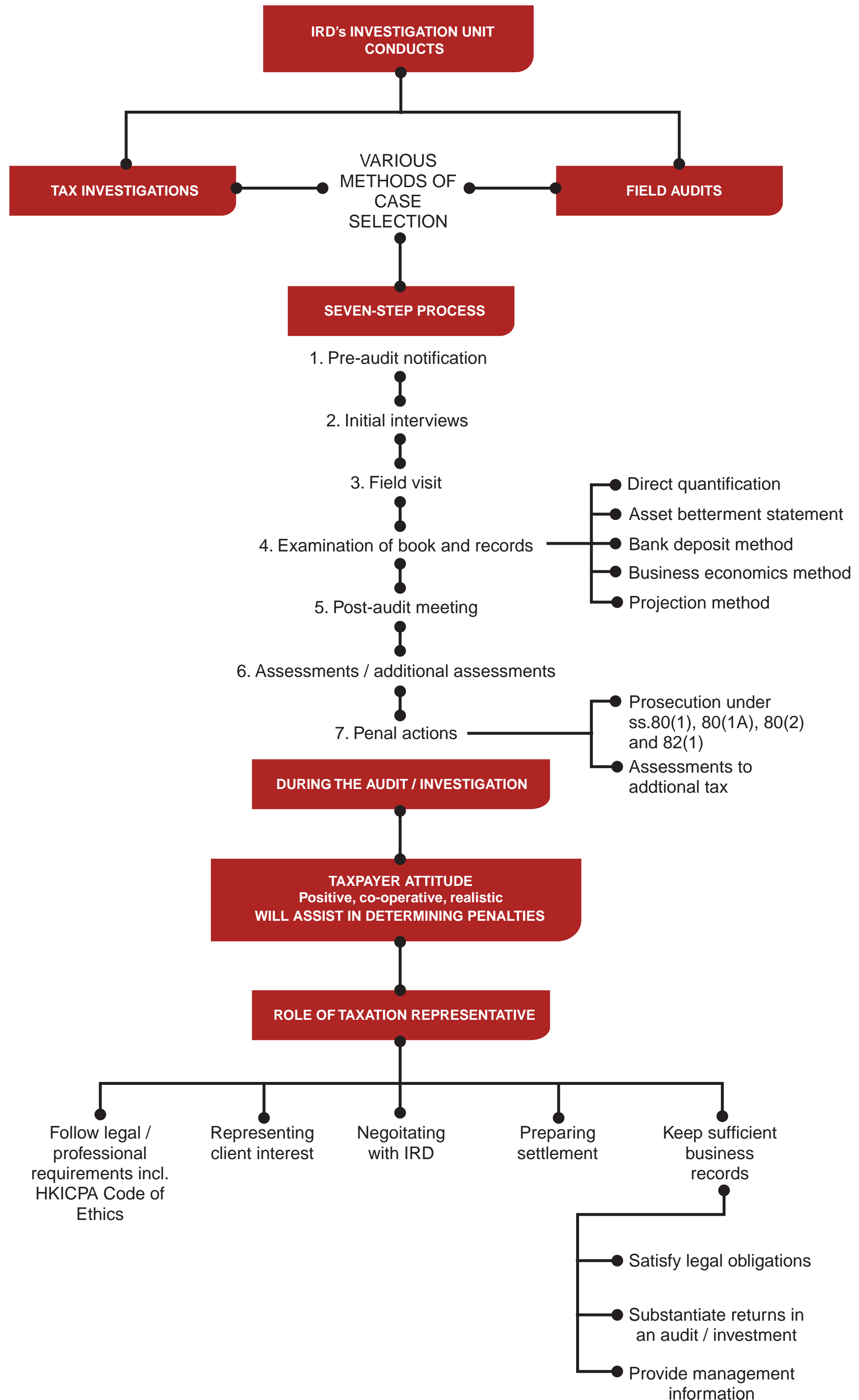
(d) Advise the obligations that are contained in the IRO with regard to the keeping of business records.

(e) Explain the advice you could give him if he appoints you as his tax representative.

HKICPA June 2002 (Amended)

(The answer is at the end of the chapter)

Topic recap



Answers to self-test questions

Answer 1

Assuming there are five years covered by the investigation, a 'top and tail' ABS can be prepared as follows:

Assets Betterment Statement for the period from (Date 1) to (Date 2)

		At the start of business (Date 1)	*Latest accounting year end date (Date 2)*
		HK$	HK$
Assets:	Business	200,000	300,000
	Private		
	Property		5,000,000
	Bank deposits ($1m + $100,000)		1,100,000
	Listed securities		2,000,000
Total assets		200,000	8,400,000
Liabilities:	Business	–	–
	Private – mortgage loan	–	(2,000,000)
	Total liabilities	–	(2,000,000)
Net assets		200,000	6,400,000
Increase in net assets			6,200,000
Add:	Disallowable expenditures		
	Living expenses (to be justified from circumstances)		600,000
	Mortgage loan interest		800,000
	Legal costs, etc. incurred on purchase of residence		200,000
			7,800,000
Less:	Non-taxable receipts		
	Interest income		(400,000)
Betterment profits			7,400,000
Less:	Returned profits		(600,000)
Discrepancy (additional profits)			**6,800,000**

After the discrepancy is agreed by the taxpayer and the IRD, the amount will be allocated to the period covered to form a basis for assessments or additional assessments.

After the assessments or additional assessments are final and conclusive, the IRD will consider taking penal actions against the taxpayer.

If the Commissioner or a Deputy Commissioner invokes s.82A, the maximum amount of the additional tax will be 300% of tax undercharged or that would have been undercharged. It has also been indicated by the BOR in a number of cases that the starting point or the norm of an additional tax penalty should be 100% of tax undercharged or that would have been undercharged.

Answer 2

With regard to the specific omission, the keeping of secret personal bank account to conceal the omitted sales proceeds, the magnitude of understatement, the recurrent omission over three consecutive years, Mr Lee's wilful intent to evade tax is *prima facie* established. Prosecution for offences contrary to s.82(1)(a), (d) and (g) is likely to be instituted against Mr Lee. On summary conviction, the maximum penalty for each charge is a fine at level 3 ($10,000) plus treble the amount of tax undercharged and imprisonment for six months under s.82(1A)(a). On indictment, the maximum penalty for each charge is a fine at level 5 ($50,000) and a further fine of treble the amount of tax undercharged and imprisonment for three years under s.82(1A)(b). The Commissioner may compound the offences under s.82(2) and may before judgment stay or compound any proceedings thereunder.

Alternatively, falling short of a proof of wilful intent, prosecution for offences of a lesser extent, contrary to s.80(2)(a), making of incorrect return without reasonable excuse may be invoked against Mr Lee. The maximum penalty is a fine at level 3 and a further fine of treble the amount of tax undercharged. The Commissioner may compound the offences under s.80(5) and may before judgment stay or compound any proceedings thereunder.

The bookkeeper, being in charge of the business accounts and the holder of the secret bank account, is likely to be prosecuted for wilfully with intent to assist Mr Lee to evade tax (ss.82(1)(a), (d) and (g)) or alternatively, for the lesser offence under s.80(4) for aiding, abetting or inciting Mr Lee to commit an offence under s.80(2)(a). The Commissioner may compound these offences under ss.82(2) and 80(5) and may before judgment stay or compound any proceedings thereunder.

If no prosecution under ss.80(2) or 82(1) has been instituted, which is unlikely in Mr Lee's case, the Commissioner or a Deputy Commissioner may penalise Mr Lee by way of an assessment to additional tax under s.82A up to a maximum of treble the amount of tax undercharged. Section 82B provides Mr Lee with a right of appeal to the BOR against the imposition and/or quantum of additional tax assessed.

The burden of proof for both ss.82(1) and 80(2) offences is on the prosecution to prove beyond reasonable doubt. The burden of proof for an appeal against a s.82A assessment is on Mr Lee to prove on a balance of probability.

Illiteracy, ignorance of law and reliance on professionals (not to say bookkeepers) are not acceptable defences in a criminal prosecution. Nor are they reasonable excuses in terms of ss.80 and 82A. Mr Lee's co-operation and prompt offer to pay the tax undercharged might be considered as mitigating factors when passing sentence or imposing monetary penalties. His concealment of the secret bank account, the time span and magnitude of understatement, however, are aggravating factors.

Answer 3

(a) There are various ways that the IRD may know that Peter received rebates from customers that are not reported nor disclosed to the IRD. These include (1) from informers (e.g. his staff), (2) from notable changes in his assets (e.g. he purchases a property in Hong Kong), (3) from payers who reported these rebates to the IRD (e.g. as a result of a field audit of the customer who gave rebates to Peter).

(b) Usually the profits understated can be directly obtained based on the specific information, especially when there are records showing the amount of rebates received by Peter.

If no records have been kept, the amount of rebates can be estimated indirectly from analysis of the transactions in his bank accounts, identifying any unexplained deposits that will be considered as rebates. In an extreme case, the ABS method can be used. Under this method, assets and liabilities of Peter at each year-end are ascertained, and increase in net assets (plus the private expenditures) will be regarded as the estimated rebates received.

(c) A taxpayer who has income subject to tax in Hong Kong is required to report in his tax return all the information about his income. Failure to observe this obligation without reasonable

excuse is an offence under s.80(2)(a), which may result in a fine at level 3 ($10,000) plus treble the amount of tax undercharged if prosecuted. The Commissioner may offer a penalty of a smaller sum. Instead of prosecuting the taxpayer, the Commissioner may assess the taxpayer to a penalty tax under s.82A of an amount up to treble the amount of tax undercharged.

(d) The statutory obligation to keep business records is contained in s.51C which requires every person carrying on a trade, profession or business to keep sufficient records, either in English or Chinese, of the income and expenditure to enable the assessable profits to be readily ascertained. Further, there is an obligation to retain such records for at least seven years after the transactions to which they relate, subject only to the following exceptions (neither of which is relevant to Peter's case):

(1) When a corporation has been dissolved all records may be destroyed.

(2) Records may be destroyed in any other case where the Commissioner gives his consent.

'Records' include books of account (whether in legible form or by computer), receipts and payments, income and expenditure, together with vouchers, bank statements, invoices, receipts and other documents necessary to verify the entries in the accounts. It also includes records of assets and liabilities, goods purchased and sold, details of sellers and buyers, records of stocktakings and records of services provided.

(e) As explained in the penalty policy of the IRD (**http://www.ird.gov.hk/eng/pol/ppo.htm**), the penalty imposed under s.82A (which is likely to be in Peter's case) depends on the degree of co-operation by a taxpayer. A taxpayer who makes a full voluntary disclosure as soon as he notices that his tax affairs are not in order will usually receive a lesser penalty than a taxpayer who makes a nominal or partial disclosure. Hence, a proper advice to Peter is to encourage him to confess the understatement as soon as possible, and to co-operate with the IRD in handling his case.

Exam practice

Mr. Chan **36 minutes**

Mr. Chan is the owner of an unincorporated business in Hong Kong. The value of his business at 31 December 2012 was estimated to be $2 million (net book value $1 million).

In addition to the business, he had the following assets and liabilities as at 31 December 2012.

	Cost	*Valuation*
Assets:	$	$
A flat at Causeway Bay	3,000,000	4,000,000
Sterling deposit in Hong Kong Bank, Central Branch	1,000,000	1,100,000
A flat in Macau	500,000	600,000
Antiques in a safe deposit box in Macau	2,000,000	5,000,000
Total assets	6,500,000	10,700,000
Liabilities:		
Mortgage loan with Bank of East Asia for the purchase of the Causeway Bay property	2,000,000	2,000,000
Total liabilities	2,000,000	2,000,000
Net assets	4,500,000	8,700,000

The net assets (private and business) of Mr. Chan ten years ago were about $1 million. In the past ten years, Mr. Chan only returned total business profits of $1.5 million. After electing for personal assessment, no tax was paid.

Recently Mr. Chan received a letter from the IRD requesting him to attend an interview with the field audit team. Mr. Chan decided that he should close down his business and leave Hong Kong. He immediately destroyed all the records of his business. However, he was unable to leave Hong Kong as he suffered a heart attack. Mr. Chan is very old and his health is deteriorating and he expects that he may die within a few years.

Required:

(a) Explain to Mr. Chan the time limit for the IRD to recover the tax undercharged from his business. **(6 marks)**

(b) Explain to Mr. Chan the approach that may be adopted by the field audit team in ascertaining the amount of the profits of his business in the absence of business records and list the information required in adopting such method. **(7 marks)**

(c) Explain to Mr. Chan the penalty actions that may be initiated by the IRD. **(7 marks)**

(Total = 20 marks)

Herbert 22 minutes

Herbert has carried on an insurance agency business on his own account. Three months ago, the IRD informed Herbert that a tax audit would be conducted in respect of his business accounts for the year ended 31 March 2013. Herbert engaged J & Co. to handle the audit.

After examining the relevant accounts and records, J & Co found that Herbert had omitted from his accounts an initial signing fee received pursuant to his service contract with the insurance company he joined on 1 July 2012. If he terminates his service contract within five years, he would be required to repay a portion of the initial signing fee. In addition, J & Co failed to locate certain invoices and receipts in relation to the expenses claimed in the accounts.

Required:

(a) Discuss whether, and if so when, the initial signing fee should be assessed to profits tax. **(6 marks)**

(b) Assuming that you are the partner of J & Co, evaluate, from the ethical perspective,

(i) how you will advise Herbert in light of the findings stated in the question; and **(3 marks)**

(ii) what you should do if Herbert has made some fictitious invoices and receipts, and asks you to submit them to the IRD to substantiate the expense claims. **(3 marks)**

(Total = 12 marks)

HKICPA December 2011 (Amended)

D & Co 9 minutes

Recently, D & Co has been engaged to review the tax affairs of A Ltd for the year of assessment 2012/13. D & Co found that A Ltd did not report its taxable profits from selling the shares in B Ltd and its consultancy income from the Mainland clients for profits tax purposes.

Required:

Discuss from the ethical perspective of a tax advisor, how D & Co should act in view of A Ltd's failure to report to the IRD its taxable profits from selling the shares in B Ltd and its consultancy income from Mainland clients. **(5 marks)**

HKICPA December 2011 (Amended)

Further reading

Suggested References

When studying this topic we suggest the following references:

Primary References

Advanced Taxation in Hong Kong, Pearson (Chapter 21)

Hong Kong Master Tax Guide, CCH Hong Kong Ltd (Chapter 12)

Hong Kong Taxation – Law & Practice, The Chinese University Press (Chapter 7)

Hong Kong Taxation and Tax Planning, Pilot Publishing Co Ltd (Chapters 4 and 5)

Inland Revenue Ordinance (Part IV, Part IX, Part X and Part XIV)

DIPN 11 (Revised) Field Audit and Investigation

DIPN 12 (Revised) Commissions, rebates and discounts

Supplementary Reference

Hong Kong Tax Manual, CCH Hong Kong Ltd (Para 25)

Part F

Tax compliance, tax advisory and double taxation arrangement

Although it is a relatively simple system, the Hong Kong tax system still provides challenges to taxpayers, especially small enterprises. Taxpayers should understand their rights and obligations. Tax representatives can help in the process. In the international tax arena, the increasing importance of the double taxation arrangement or agreements means an in depth understanding is now essential.

chapter 11

Tax compliance and tax advisory services

Topic list

1 Legal and professional obligations
- 1.1 The Taxpayer's Charter
- 1.2 Professional requirements
- 1.3 Ethics in Tax Practice

2 Tax compliance within an organisation
- 2.1 Profits tax filing
- 2.2 Application for exemption from property tax
- 2.3 Salaries tax filing
- 2.4 Recording tax liability and arranging payment of tax
- 2.5 Providing further information as required to IRD
- 2.6 Keeping sufficient business records

3 Management of taxation work and projects
- 3.1 Staffing of the taxation function in an organisation

4 Tax compliance services by tax representatives
- 4.1 Profits tax filing
- 4.2 Application for exemption from property tax
- 4.3 Salaries tax filing

5 Providing further information as required by the IRD
- 5.1 Replying to an IRD enquiry
- 5.2 Lodgement of objections against incorrect assessments
- 5.3 Lodgement of s.70A claim to correct an error or omission in a tax return or statement
- 5.4 Submission of holdover application for provisional profits tax

6 General tax advisory services by tax representatives

7 Special tax advisory services by tax representatives
- 7.1 Application for Advance Rulings
- 7.2 Tax Investigation and Field Audit
- 7.3 Appeal to the Board of Review under s.66 against a determination by the Commissioner
- 7.4 Appeal to the Board of Review under s.82B against an additional tax assessment raised by the Commissioner or a Deputy Commissioner under s.82A

Learning focus

It is important to have an understanding of the legal, professional and ethical obligations of tax representatives. Tax representatives are responsible for taxation compliance services including filing of tax returns. They must provide documentary evidence upon the IRD's request and prepare replies in response to the IRDs enquiries.

Learning outcomes

In this chapter you will cover the following learning outcomes:

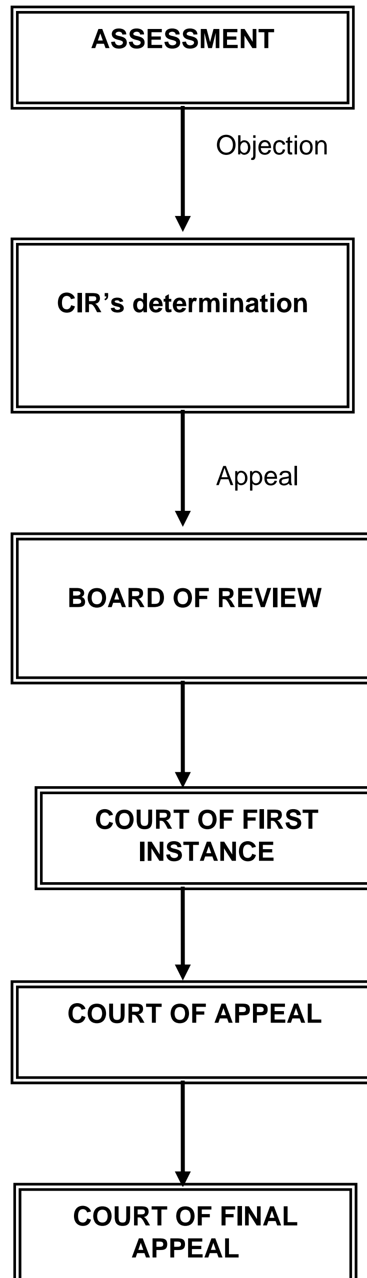
		Competency level
Describe the key aspects of the tax system in Hong Kong		
1.01	**Principles of taxation**	2
1.01.03	Describe the roles of the taxpayer, tax advisor and the Inland Revenue Department (IRD)	
1.14	**Board of Review**	2
1.14.01	Describe the role and formation of the Board of Review	
Describe the role of the Professional Accountant in tax management		
3.01	**Professional and ethical standards**	3
3.01.01	Identify and explain the importance of the ethical considerations in tax planning	
3.02	**Relationship with tax authority and the law**	2
3.02.01	Explain the relevant issues in relation to: – Tax advice letter to a client – Reply to an IRD enquiry letter – Objection letter to IRD – Holdover application to IRD – S.70A claim letter to IRD	

1 Legal and professional obligations

Topic highlights

The taxpayer, the tax advisor, and the tax authority (IRD) all have obligations under the law. The Taxpayer's Charter outlines the rights and obligations of the IRD and the taxpayer.

All tax representatives should observe professional ethics in rendering tax services to their clients.



Taxpayers have an obligation to comply with the provisions of the tax ordinances (i.e. tax compliance). They also have a right to arrange their affairs in order to minimise the resulting tax by lawful means while not infringing any anti-avoidance provisions (i.e. tax planning).

For general tax compliance, taxpayers may get help from the IRD. For tax planning issues, they may need to seek advice from tax professionals who have the required technical competency and professional ethics.

The following is a general comparison of the objectives of the taxpayer, the tax advisor and the tax authority (IRD).

Person	Objectives
Taxpayer	• To comply with the law. • To minimise or defer the tax liabilities by lawful means, without incurring excessive professional or other charges.
Tax advisor	• To comply with the law. • To provide timely professional advice to clients to help them comply with the provisions of the tax ordinances. • To provide professional advice to clients and help them to plan their tax affairs effectively and efficiently • To protect the interests of clients. • To keep information obtained from clients confidential. • To provide information to the IRD as approved by clients. • To maintain a good relationship with clients. • To maintain a good relationship with the IRD. • To observe professional ethics in rendering tax services. • To charge a fair fee on tax services rendered.
Tax authority	• To enforce the provisions of the tax Ordinances. • To help taxpayers comply with the provisions of the tax ordinances by providing Internet, telephone and counter enquiry services. • To help taxpayers and their representatives comply with the provisions of the tax ordinances by issuing Departmental Interpretation and Practice Notes . • To keep information relating to taxpayers' affairs confidential. • To prosecute or impose penalty on taxpayers for non-compliance with the provisions of the tax ordinances. • To collect tax that is payable by a taxpayer on the due date. • To impose surcharges on late payments of tax. • To recover tax and surcharges from tax defaulters by legal actions in the Courts. • To deter tax evasion by conducting tax investigations or field audits. • To prosecute tax evaders or any other persons who have assisted the taxpayer to evade tax. • To deter tax avoidance.

1.1 The Taxpayer's Charter

In 2000, the IRD issued 'The Taxpayer's Charter', which outlines the rights as a taxpayer (payment of tax due under the law, courteous treatment, timely professional service, privacy and confidentiality, access to information, bilingual service, complaints and appeals) and the obligations as a taxpayer (honesty, lodgement of returns, documents and information, tax payment, record keeping, keeping IRD posted). Details of the Charter can be found on the website of the IRD at **http://www.ird.gov.hk/index.htm**.

To facilitate better communication with tax representatives, the IRD has maintained a '**Tax Representatives' Corner** ' on its website since 1 April 2003. The Corner aims at providing tax representatives materials (such as highlights of changes in tax returns (both paper form and electronic form), special points to note in completing tax returns, updated FAQ on completion of tax returns, etc) that are considered to be helpful to the representatives in the preparation and lodgement of profits tax returns. Details can be found on the website of the IRD at **http://www.ird.gov.hk/eng/tax/taxrep.htm**.

1.2 Professional requirements

At present, there is no qualification or experience requirement for a person to act as a tax advisor. Any person may be appointed as a tax representative of a taxpayer. The Board of Review , in a few circumstances, has expressed concern about the performance of certain tax representatives.

Unlike that operated for Certified Public Accountants (CPA), there is no registration system of tax representatives in Hong Kong. Neither is there any peer review nor any control mechanism over the quality of the tax services of the tax representatives. Nevertheless, the Hong Kong Institute of Certified Public Accountants (the Institute), in its Members' Handbook, has provided guidance to its members on professional ethics (including ethics in tax practice). See the website of the Institute at **http://www.hkicpa.org.hk** for details.

It should be noted that failure to follow the guidance given by the Institute does not of itself constitute misconduct, but means that the member concerned may be at risk of having to justify his actions in answering to a complaint.

1.3 Ethics in Tax Practice

It is advisable that all tax representatives (not necessarily just the members of the Institute) should observe professional ethics in rendering tax services to their clients. In general, ethical issues include the following:

- Integrity;
- Objectivity;
- Competence;
- Fairness;
- Confidentiality;
- Professionalism; and
- Diligence.

Members of the Institute are required to comply with the Code of Ethics for Professional Accountants (Revised June 2010). Tax representatives should pay particular attention to **s.430** "**Ethics in Tax Practice**" which is reproduced below:

This section should be read in conjunction with s.200 "Introduction" to Professional Accountants in Public Practice .

Fundamental Principles

430.1 The fundamental principles to be observed when developing ethical requirements relating to tax practice include all five Fundamental Principles by which a member is governed in the conduct of his professional relations with others. These principles are enumerated in

s.100 "Introduction and Fundamental Principles", paragraphs 100.4 and expanded upon in the rest of the Code.

Development of the Fundamental Principles

430.2 A member rendering professional tax services is entitled to put forward the best position in favour of his client, provided he can render the service with professional competence, it does not in any way impair his standard of integrity and objectivity, and is in his opinion consistent with the law. He may resolve doubt in favour of his client if in his judgment there is reasonable support for his position.

430.3 A member should not hold out to clients the assurance that the tax return he prepares and the tax advice he offers are beyond challenge. Instead, he should ensure that his clients are aware of the limitations attaching to tax advice and services so that they do not misinterpret an expression of opinion as an assertion of fact.

430.4 A member who undertakes or assists in the preparation of a tax return should advise his client that the responsibility for the content of the return rests primarily with the client. The member should take the necessary steps to ensure that the tax return is properly prepared based on the information received from the client.

430.5 Tax advice or opinions of material consequence given to a client should be recorded either in the form of a letter to the client or in a memorandum for the files.

430.6 A member must not associate himself with any return or communication which he has reason to believe:

(a) contains a false or misleading statement;

(b) contains statements or information furnished by the client recklessly or without any real knowledge of whether they are true or false; or

(c) omits or obscures information required to be submitted and such omission or obscurity would mislead the Inland Revenue Department.

If any of the above situations prevails, the member’s responsibility is to resign from acting as the client’s tax representative. Having resigned the member should:

(a) inform the Inland Revenue Department that he has withdrawn his services.

(b) give no further information to the authorities without the consent of the client, unless required to do so by law.

430.7 A member may prepare tax returns involving the use of estimates if such use is generally acceptable or if it is impractical under the circumstances to obtain exact data. When estimates are used, they should be presented as such in a manner so as to avoid the implication of greater accuracy than exists. The member should be satisfied the estimated amounts are reasonable under the circumstances.

430.8 In preparing a tax return, a member ordinarily may rely on information furnished by his client provided that the information appears reasonable. Although the examination or review of documents or other evidence in support of the client’s information is not required, the member should encourage his client to provide such supporting data, where appropriate.

In addition, the member:

(a) should make use of his client’s returns for prior years whenever feasible.

(b) is required to make reasonable inquiries where the information presented appears to be incorrect or incomplete.

430.9 The member’s responsibility when he learns of a material error or omission in a client’s tax return of a prior year (with which he may or may not have been associated), or of the failure of a client to file a required tax return, is as follows:

(a) He should promptly advise his client of the error or omission and recommend that the client make disclosure to the Inland Revenue Department. Normally, the member is not obligated to inform the Inland Revenue Department, nor may he do so without his client's permission.

(b) If the client does not correct the error:

   (i) the member should inform the client that he cannot act for him in connection with that return or other related information submitted to the authorities;

   (ii) the member should consider whether continued association with the client in any capacity is consistent with his professional responsibilities;

   (iii) and if the member concludes that he can continue with his professional relationship with the client, he should take all reasonable steps to assure himself that the error is not repeated in subsequent tax returns.

(c) If because of the error or omission, the member ceases to act for the client, in these circumstances, the member should advise the client of the position before informing the authorities of his having ceased to act and should give no further information to the authorities without the consent of the client, unless required to do so by law.

2 Tax compliance within an organisation

Topic highlights

The compliance work of an organisation during a tax year will largely depend on its size and the nature of its business.

The following are the general tax compliance issues of an organisation:

- profits tax filing;
- application for exemption from property tax (for corporations only);
- salaries tax filing (employer's return);
- recording tax liability and arranging payment of tax;
- providing further information as required by the tax authority; and
- keeping sufficient business records.

2.1 Profits tax filing

The IRD usually issues profits tax returns (Form BIR 51 for a corporation and Form BIR 52 for a business other than a corporation) on 1 April each year. Depending on the accounting date of the business, the returns have to be completed and filed with the IRD within the time limit under the block extension system as follows:

Accounting Date	Code	Normal Tax Filing Deadline	Tax Filing Deadline for 2012/13
1 Apr – 30 Nov	N	30 April (no extension)	2 May 2013
1 Dec - 31 Dec	D	15 August	15 August 2013
1 Jan - 31 Mar	M	15 November. and further extension for tax loss cases	15 November 2013 4 February 2014 for loss cases

Except for a 'Small Corporation' or 'Small Business' (see note below), the profits tax return has to be filed with:

- A certified copy of the Statement of Financial Position, Auditor's Report (for Corporation) and Profit and Loss Account / Income Statement;
- A tax computation with supporting schedules showing how the Assessable Profits/Adjusted Loss is arrived at; and
- Other documents and information as specified in the Notes and Instructions enclosed with the return.

In general, the IRD requires supporting schedules and explanations in respect of the following items:

- Extraordinary gains and losses;
- Interest expenses;
- Interest claimed to have an offshore source;
- Offshore profits and apportionment of related expenses;
- Fees paid (names/addresses and nature);
- Sub-contractors' fees (names/addresses and amounts);
- Legal and professional fees (names and nature of services);
- Repairs and improvements;
- Commission payments;
- Bad debt provisions and write-offs;
- Leasehold improvements;
- Movements in reserves and provisions; and
- Purchase and sale of capital assets, including properties.

The IRD provides '**Common Questions & Answers on Completion of Profits Tax Returns (BIR 51 & BIR 52)** ' in its website **http://www.ird.gov.hk/eng/faq/cpt51.htm**.

Sometimes the tax returns and supporting tax computation schedules are prepared by the tax representatives of the taxpayers. Nevertheless, in all circumstances, it is the taxpayer's responsibility to ensure that the returns are correct and are submitted within the time limit.

Note: If the total **gross** income (all types of income including sales and other ordinary business income, proceeds from sale of capital assets and other non-taxable income whether or not derived from the principal business activity) of a company for the basis period of a year of assessment does not exceed $2,000,000, then the company is a 'Small Corporation' or 'Small Business' (unincorporated).

As a 'Small Corporation', the company needs not submit the supporting documents (i.e., the statement of financial position, profit and loss account, auditors' report and profits tax computation) with the return. However, the taxpayer must prepare the supporting documents before the return is completed.

2.2 Application for exemption from property tax

Corporations carrying on business in Hong Kong may apply for exemption under s.5(2) from property tax . Usually the applications can be made in the property tax returns (Form BIR 57).
If no application has been made, any property tax paid by the company may be used to offset the company's profits tax liability under s.25 of the IRO.

If there is any change in the ownership or use of the property or in other circumstances affecting the exemption, corporations exempted from property tax need to inform the Commissioner of the change in writing within 30 days after the event.

2.3 Salaries tax filing

The IRD usually issues employers' returns (Form BIR 56A and Form IR 56B) on the first working day of April each year. The forms need to be completed and submitted to the IRD usually within one month from the date of issue. Some companies may find it difficult if there are a large number of employees. The employers' returns may be submitted in computerised format using IRD software or software approved by the IRD. An employer also needs to submit the following returns:

Return	Form	Time Limit
Employer's Return on commencement of employment.	IR 56E	three months from date of commencement of employment.
Employer's Return on cessation of employment.	IR 56F	one month before date of cessation of employment.
Employer's Return in respect of an employee who is about to leave Hong Kong.	IR 56G	one month before date of departure.

The IRD may accept shorter notice if there is a reasonable cause. For any non-compliance offence committed by an employer without a reasonable excuse, the maximum penalty is a fine at level 3 (i.e. $10,000) and the Court may grant an order requesting the employer to submit the return within the time specified in the order. Alternatively, the Commissioner may compound the offence.

For payments made by a company to individuals, the company may, upon request, be obligated under s.51(4) to file a Form IR 56M on certain individuals as follows:

Any commission, fees or other remuneration paid to local residents in the capacity of:

1. sub-contractors exceeding $200,000 per annum; and
2. consultants, agents, brokers, freelance artistes, entertainers, sportsmen or writers etc in excess of $25,000 per annum.

The Form IR 56M should be filed for each of the recipients together with the declaration form IR 6036B .

If the payment is made to non-resident persons who rendered services in Hong Kong, the company is required to notify the IRD via a Form IR 623 when the non-resident arrives in Hong Kong; and withhold an amount from payments made to the non-resident sufficient to produce the amount of tax due in accordance with ss.20A and 20B of the IRO, if applicable.

The Form IR 56M is not applicable if the recipient is a corporation.

2.4 Recording tax liability and arranging payment of tax

The IRD usually issues notices of assessment for profits tax after July each year. Payment due dates differ with regard to the respective accounting dates of the businesses. For N code cases, there is no second instalment for the provisional profits tax.

Tax payments usually represent significant cash outflows of a business. Late payment may give rise to 5% and 10% surcharges and recovery actions through the district courts. It is therefore important for the business to record the tax liability and make proper arrangement for payment of tax.

In general, a provision for profits tax is accrued and recorded in the books of accounts as a liability before a profits tax assessment is received. However, the making of the provision of profits tax in the accounting records does not of itself mean that there is sufficient cash for the payment of tax

when due. Although tax payment may only be made some time after the demand notice is received, it is not a good practice to arrange for the finance of the tax payments only after receipt of the demand notice. Management should plan for the impact of the tax payments in their cash flow forecast. If the tax is to be paid by two instalments, it is important to maintain a bring-up system for both instalments.

The IRD encourages taxpayers to make payment of tax by Tax Reserve Certificates (TRCs). With effect from 1 September 1999, the IRD has implemented an 'Electronic Tax Reserve Certificate Scheme ' for taxpayers in general. On the tax due dates, a taxpayer who is a participant of the Scheme will enjoy the 'Auto Tax Payment Service ' provided under the Scheme which ensures on-time tax payment. The electronic TRCs held in the TRC account will be automatically redeemed, with interest accrued, for payment of the TRC account holder's tax.

A mid-year statement will be issued by the IRD to the TRC account holders in September every year showing the account balance as at 31 August of the year. TRC account holders can also check their account details at any time by requesting a statement from the IRD or via their eTAX accounts.

On S.71 of the IRO was amended on 12 February 2010 to enable the Commissioner to refund to a taxpayer the balance remaining in the Tax Reserve Certificates accounts without requiring the taxpayer to return the Tax Reserve Certificate to the Commissioner.

2.5 Providing further information as required to IRD

If there are enquiries from the IRD, the taxpayer will need to provide further information within the time limit specified in the IRD letter that is usually one month after the date of the notice. The IRD may grant an extension of time if there are reasonable grounds.

The requested information may either be facts (for example, a detailed breakdown of legal and professional fees) or arguments (for example, on what grounds that a gain is capital in nature and therefore not taxable).

In general, providing information on facts is much easier than supporting a claim with arguments. In the latter case, advice is often needed from tax professionals with reference to judicial precedents or other authorities.

2.6 Keeping sufficient business records

Under s.51C of the IRO, persons chargeable to profits tax in Hong Kong need to keep sufficient business records in Chinese or English for at least seven years after completion of the transactions, acts or operations. Failure to keep proper records may be penalised by a fine at level 6 (i.e. $100,000). Alternatively, the Commissioner may compound the offence.

Business records may include:

- records of assets and liabilities;
- records of trading stocks;
- records of receipts and revenue;
- records of payments and expenses;
- records of bank accounts; and
- records of depreciation allowances.

Records need not be kept:

- for a corporation which has been dissolved; or
- if approval has been obtained from the Commissioner.

The IRD has issued a pamphlet '*A Guide to Keeping Business Records*' and also a leaflet '*Admissibility of Business Records Kept in Electronic Form for Tax Purposes*' for the information of the taxpayers.

3 Management of taxation work and projects

Topic highlights

Tax is, in essence, a management function within an organisation. Taxation work within an organisation involves proper planning, implementation and evaluation.

For tax compliance work, management needs to ensure that all required compliances are done within the time limit. In general, most tax compliance work has a regular pattern and time frame (e.g., profits tax returns are issued in April, employer's returns for employees are issued in April).

The importance of planning is that remedies can be taken before things go wrong. For example, if there is an increased number of employees, management should be aware that more employer's returns will need to be submitted and more staff should be allocated for this task in the coming April.

Although the tax rate in Hong Kong is low, a cash outflow of profits tax (15% or 16.5% on taxable profits) is still likely to be significant in most circumstances. The impact of tax (including deferred tax) should be fully considered by management in planning any strategic move of the business.

3.1 Staffing of the taxation function in an organisation

The taxation functions in an organisation are likely to be performed by the Accounting Department. The following are some of the concerns in assigning taxation work to staff in an organisation.

Taxation Work	Confidentiality	Technical Competency	Staffing Concern
Profits tax filing	High	High	Profits Tax computations are based on the financial accounts of the organisation with adjustments of tax deductible and non-deductible items, non-taxable items and depreciation allowances. Since the preparation of a profits tax computation involves confidential information of the organisation, such work should not be performed by junior accounting staff. However, supporting schedules such as breakdown of bad debts, additions to fixed assets, etc., may be prepared by junior staff under the supervision of the accountant. Staff preparing the profits tax computation should also have a high level of technical competency in taxation as well as a thorough understanding of the activities undertaken by the organisation. The completed tax return and supporting tax computation schedules have to be approved by executives before submission to the IRD.

Taxation Work	Confidentiality	Technical Competency	Staffing Concern
Application for exemption from property tax	Low	Low	The completion of a property tax return with application for exemption from property tax does not involve much technical knowledge. The form may be completed by clerical staff with details being checked by a supervisor.
Salaries tax filing	High	Low	Preparation of employer's return may be performed by either the personnel department (human resources) or the accounting department of an organisation. Since payroll records are confidential, the preparation of the returns should not be assigned to junior staff of an organisation. Junior clerical staff may be asked to complete details of the employees such as name, ID card number and address on the forms before the income figures of the employees are filled in by senior executives. It is a good practice to pass a copy of the completed employer's return to the employee concerned for verification before submission to the IRD.
Recording tax liability and arranging payment of tax	High	Low	The Financial Controller or Treasurer of an organisation should ensure that tax is paid on or before the due dates to avoid surcharges or recovery actions by the IRD. Clerical staff should maintain a bring-up system to remind the executives in charge about the tax due dates. However, the amount of tax payment is confidential and should be restricted to accounting staff responsible for the records. Maintaining sufficient amount of tax reserve certificates in an "Electronic Tax Reserve Certificate Scheme" with the IRD will also ensure on-time tax payment.
Providing further information as required by the tax authority	Medium to high	Medium to high	The work may be assigned to different levels of staff with respect to the nature of the information requested. In general, factual information may be provided by junior staff as this does not require taxation knowledge (for example, junior accounting staff may be asked to look into the records to compile a breakdown of sundry expenses). Submitting arguments to the IRD requires technical knowledge of tax and may be performed by executives and supplemented by independent professional advice as may be required.

Taxation Work	Confidentiality	Technical Competency	Staffing Concern
			The executives in charge should go through all information before it is submitted to the IRD (for example, there may be disallowable items in the sundry expenses that require adjustments to assessable profits).
Keeping sufficient business records	Medium to high	Medium	The business records required under s.51C of the IRO are likely to be kept by the accounting department of an organisation. Records kept for accounting purposes should also fulfil the needs of the IRD.
Tax planning	High	High	Generally, only the directors or chief executives of an organisation may be involved in tax planning issues. Professional advice may also be sought from tax advisors. It is best that any tax planning is done before the transaction. If circumstances warrant, the transaction can be restructured to achieve tax efficacy. Accounting department staff may be asked to provide management accounts, budgets, cash flow forecast and financial analysis for the information of the directors or chief executives in the planning stage. Far too often, the accounting department only gets full details of transactions undertaken by senior management at the very last stages of closing the accounts. By that time, it is difficult to improve the organisation's tax position with respect to such transactions.

4 Tax compliance services by tax representatives

Topic highlights

Tax compliance services provided by tax representatives generally include profits tax filing, salaries tax filing (employer's return and individual's composite tax return), and property tax filing.

As the taxation work of an organisation often involves confidential information and technical knowledge of tax, many companies would prefer to appoint tax professionals to perform the work. In most circumstances, the tax representatives are working together with the auditors of the taxpayer and exchange of relevant information can therefore be effective.

Tax compliance services provided by tax representatives may include:

- profits tax filing;
- salaries tax filing (employer's return and individual's composite tax return);
- property tax filing.

It is a good practice to issue tax engagement letters to clients specifying the scope of the agreed tax services.

An example of a tax engagement letter is as follows:

Example: Tax engagement letter

Letterhead - X and Y Co

(Client name)
(Client address)

(Our Ref.)

Dear Sirs,

(Client name)

Profits Tax

We are pleased to accept the appointment as tax representatives of (name of client).

This letter sets out the basis on which we are to act as the company's tax representatives. (Name) will be the Tax Partner-in-charge of the engagement and (name) will be the Tax Manager.

Our Service Scope

As your company's tax representatives, we will provide the following taxation compliance services:

(a) Preparation and submission of the company's profits tax return for the Year of Assessment 20XX/XX and supporting tax computation to the Inland Revenue Department ('IRD');

(b) Review of notices of assessment issued by the IRD, lodgement of appeals against incorrect assessments as appropriate and advice on the same; and

(c) Preparation and filing of replies to the IRD concerning any queries raised in relation to the company's tax matters.

We shall also be pleased to advise on any other ad hoc taxation matters, such as reviewing the tax implications of proposed business transactions. These will be regarded as separate assignments to the compliance services above.

We can also advise directors and employees on their personal tax position. However, in such cases we will need to agree separate terms with the individuals concerned.

Your responsibilities: provision of information

There are a number of key dates by which returns and payments must be made. The company is legally responsible for making correct returns and for payment of tax on time.

To enable us to carry out our work you will:

(a) Make full disclosure to us of all sources of income, charges, allowances and capital transactions and provide full information necessary for dealing with the company's tax affairs. We will rely on the information and documents being true, correct and complete and will not audit or independently verify the information or the documents;

(b) Respond quickly and fully to our requests for information and to other communications from us;

(c) Provide us with information in sufficient time for the company's tax returns to be completed and submitted by the due date; and

(d) Ensure to the best of your knowledge and belief, such information provided to the IRD is correct and complete.

We will provide our professional services outlined in this letter with reasonable care and skill. However, we will not be responsible for any losses, penalties, surcharges or additional tax liabilities arising from the supply by you or others of incorrect or incomplete information, or your or others'

failure to supply any appropriate information or your failure to act on our advice or respond promptly to communications from us or the IRD, or from your own acts or omissions which cause a return to be filed late.

Period of engagement

These terms of engagement will remain in effect unless terminated, amended or superseded by a further written agreement or engagement.

Fees

We compute our fees based on the actual time incurred, the level of professional staff involved and disbursements incurred in connection with the engagement. Unless otherwise agreed, fees will be charged separately for each of the main items of work mentioned above and we will bill at appropriate intervals during the course of the year. Our invoices are payable on presentation.

Applicable law and jurisdiction

This engagement and any assignments arising out of same or in connection with same shall in all respects be governed by the laws of the HKSAR and the Courts of the HKSAR shall have exclusive jurisdiction in respect of same.

We trust that the terms outlined above are acceptable. Please acknowledge receipt of this letter by signing and returning the attached copy to us if it is in accordance with your understanding of our agreement.

Yours faithfully,

X and Y Co

4.1 Profits tax filing

There is no requirement that a profits tax return needs to be completed by tax professionals. Indeed the obligation to submit a correct return within the specified time limit always lies with the taxpayer.

Profits tax filing by tax representatives follows a block extension system. Tax representatives need to apply for block extension for new clients early each year. The IRD requires that the returns handled by tax representatives need to be submitted in a timely manner.

For example, the target percentages of M code tax returns for the year of assessment 2011/12 are as follows:

Date	Target Percentage of Tax Returns Submitted
31 August	25%
30 September	55%
31 October	80%
15 November	100%

Profits tax returns may be issued to taxpayers or tax representatives in April each year. Tax representatives need to compile a list of current year tax returns and plan for the profits tax filing. With regard to the submission due dates (30 April, 15 August and 15 November) of the tax returns, the tax returns will be categorised in accordance with the codes (N, D and M) under the block extension system.

Time has to be allowed for preparing the tax returns and supporting tax computation schedules, obtaining approval of the tax returns from clients before the returns can be filed with the IRD. Since the IRD may allow further extension to M code cases with current year tax losses to 31 January of the following year (e.g. 31 January 2014 for 2012/13 loss cases), priority of filing is

usually given to cases with assessable profits. The profits tax returns of each of the categories (N, D and M) may be prioritised by a tax representative with regard to the following issues:

- whether it is likely to have any assessable profits or allowable loss for the year of assessment (further extension may be allowed by the IRD for loss companies);
- whether overseas approval is required (time needs to be allowed for sending the return/computation overseas);
- whether the computation is complex (e.g. large manufacturing company);
- whether the computation involves knowledge of special industries (e.g. financial institutions).

Depending on the technical requirements of the tax computations, the preparation of tax returns will be assigned to different grades of staff with the required competency.

Draft tax returns and supporting tax computations will be reviewed by executives in charge before they are sent to clients for approval. There is usually a covering letter drawing client's attention to the basis of the tax computations and areas of concern.

A follow up mechanism should be maintained to ensure that the returns are approved and returned by clients with sufficient time allowed for submission to the IRD before the tax deadline. If the clients cannot return the tax returns in time, application for extension of time for submission should be arranged as soon as possible.

In general, the fees paid to tax representatives for profits tax filing are tax deductible.

After submitting the tax returns, the tax representatives may provide follow-up services to clients, such as:

- providing further information as required by the tax authority;
- lodging objections against incorrect assessments;
- lodging s.70A claim to correct an error or omission in a tax return or statement; and
- submitting a holdover application for provisional profits tax.

4.2 Application for exemption from property tax

There is no major difference between the application for exemption from property tax by an organisation or its tax representatives.

In essence, clients' approval of the application has to be obtained before the property tax return or application letter is prepared by the tax representatives.

4.3 Salaries tax filing

In general, salaries tax filing does not require a high level of technical knowledge. All planning issues should have been arranged before the returns are prepared.

Employer's returns may be prepared by the tax representatives as the clients may consider this would preserve confidentiality or perhaps the client's accounting and payroll records are kept by the tax representatives. There is no block extension for submission of the annual employer's returns (Forms BIR 56A and Form IR56B) handled by tax representatives (i.e. the returns have to be submitted to the IRD within one month of issue). The fees paid to tax representatives for filing employer's returns are generally deductible.

For Forms BIR56A and Form IR56B for the year of assessment 2012/13, the IRD has extended its eTAX Internet filing service (**www.gov.hk/etax**) to enable employers to file annual employer's returns online.

Bulk issues of individual's composite tax returns (Form BIR 60) are normally sent by the IRD on the first working day of May each year. Individual's composite tax returns may also be prepared by the tax representatives. Normally, highly paid taxpayers or expatriates use the services of tax representatives for individual's composite tax return filing. The fees paid to tax representatives by the individuals are not allowable deductions under salaries tax. If the payment is made and borne

by the employer of the individual taxpayer, it may constitute a discharge of the employee's personal liability and is therefore chargeable to salaries tax as an additional emolument of the employee. Nothing will be chargeable if the employer contracts with the tax representatives directly for the filing services of its employees and takes up the liability of the professional fees.

The IRD usually allows an additional one month for individual's composite tax returns handled by tax representatives (i.e. the returns have to be submitted to the IRD within two months from the date of issue). Again, it is important to allow sufficient time for obtaining all required information from the clients, sending the returns for approval and signature and then submitting the returns to the IRD.

Provisional salaries tax is usually payable by two instalments. The balance of the final tax and 75% of the provisional salaries tax is usually due in the period from January to March and the remaining 25% provisional salaries tax is payable after March.

Sometimes it is necessary to remind individual clients of the due dates of his or her salaries tax liability and to arrange for payment of the tax.

5 Providing further information as required by the IRD

Topic highlights

In order to ascertain the tax position of the taxpayers, the IRD may need further information and documentary evidence and raise enquiries on the taxpayers or third parties. Provision of further information and responses to the IRD is often handled by the tax representatives.

Since April 2001, the IRD has adopted an assessing programme called '**Assess First Audit Later**' (AFAL) for profits tax returns. Under the AFAL scheme, an assessor will not examine the taxpayers' returns. The profits tax assessment or statement of loss will be issued in the first instance as per the profits or loss stated in the tax returns provided certain pre-set conditions are satisfied.

As discussed previously, the IRD has established a system of a three-tier audit system ('**Audit Trilogy**'), whereby advanced information technology is used to assist assessing officers in conducting desk audits, field auditors in conducting field audits, and investigators in performing in-depth investigations.

The computer program of the IRD is designed to provide an objective and efficient selection process to select desk audit cases. Both the '**random selection** ' and the '**risk-based selection** ' methods are used.

The former method ensures that all returns have an equal chance of being selected, while the latter method is based on risk assessment. Risk-bearing items (e.g., claims for bad debt deductions) are assigned different weights and the scores for each risk-bearing item is computed. Returns with high total scores will be selected for desk audit. It is anticipated that the risk factors and their assigned weights will not remain static.

If understatement or evasion is suspected during the course of desk audit , audit professionals then take the case for field audit . Serious cases requiring an in-depth examination are transferred to investigators for a full tax investigation.

Requested information by the IRD may be obtained from:

- the audit file;
- the tax file;
- the client's records; and
- records from third parties (e.g. banks, lawyers, Companies Registry, Land Registry) and interpretation of whether tax is payable from:
  - decided tax cases;

– Departmental Interpretation and Practice Notes; and
– textbooks.

In general, providing factual information is much easier than supporting a claim with arguments. The factual information can either be obtained from the audit and tax files or from clients and third parties. On the other hand, extensive research into judicial precedents or other authorities may be necessary for collecting sufficient information to support an argument (e.g. capital v. revenue).

It is important to select the relevant information in answering an enquiry from the IRD. As a general guide, relevant information will:

- directly answer the questions raised by the IRD;
- support the return and tax computation; and
- explain the situation thoroughly but should not raise other matters.

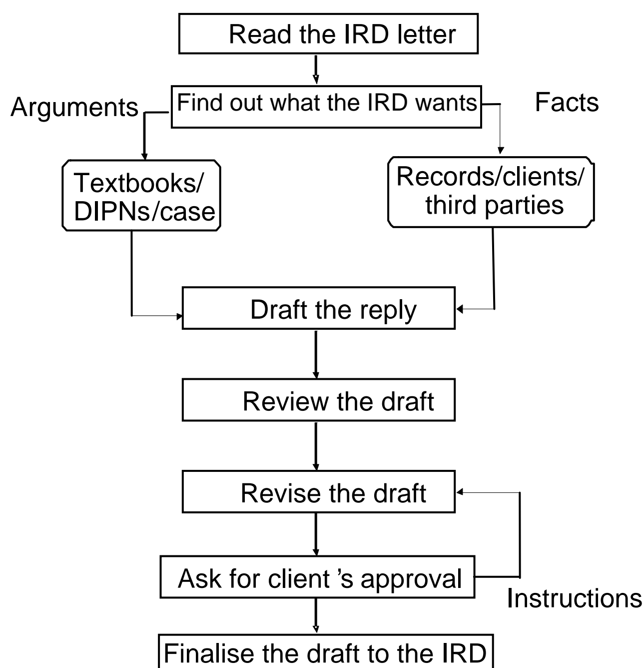
5.1 Replying to an IRD enquiry

In drafting a reply to an IRD enquiry , it is necessary to consider the responses of the recipient (i.e. the IRD officer). One should consider the draft reply from the views of the IRD to see whether the information provided in the reply is relevant and sufficient. Tables and appendices with proper indexes will help present complex information to the IRD in a logical and professional manner.

As a quality control measure, contents of the draft reply should be reviewed by a senior officer of the tax representatives before the draft is sent for client's review. It is not uncommon that a draft has to be revised several times before it is finalised. It is important to allow sufficient time for the client's review and also the final revision of the reply before it is submitted to the IRD.

Again, the contents and the enclosures of the reply have to be checked before the reply is submitted to the IRD. Follow up actions should also be taken with the IRD to ensure that the tax position of the taxpayer is agreed without delay.

The following is a general description of the procedures involved in handling an IRD enquiry letter.



Example: Draft reply to an enquiry letter from the IRD

Background information

Agent Limited, a client of X & Y Co, is a real estate agent established in Hong Kong. During the year ended 31 March 2013, it paid commission of $300,000 to its holding company, Master Limited, in Japan. The circumstances leading to the payment of the commission are as follows.

In October 2012, Master Limited introduced a purchaser from Japan to acquire a property at $60,000,000 from a client of Agent Limited. Agent Limited received commission of $600,000 from the vendor and $600,000 from the purchaser. A commission of $300,000 was then paid to Master Limited.

The IRD has raised queries on X & Y Co in respect of the tax return of Agent Limited as follows:

Re: Commission expenses of $300,000:

(1) Confirm and let me have full details if the company has paid commission to Master Limited in previous years.

(2) Let me have copies of documentary evidence to support your client's claim that the purchaser was introduced and referred by Master Limited of Japan. Let me have an English translation if the documents were in Japanese.

(3) Confirm whether the purchaser was physically in Japan when the instructions for purchase were given and explain how the execution of the provisional agreements for sale and purchase, the sale and purchase agreements and Deeds of Assignment were arranged.

(4) Confirm whether the company has any business establishment outside Hong Kong.

(5) Let me have a full list of the work done by the company for earning the commission income.

(6) Let me have a full list of the work done by Master Limited in Japan for the commission of $300,000.

(7) Explain the basis of the commission paid to Master Limited and provide copy of the service agreement, if any.

(8) Explain how the commission expenses were incurred in the production of assessable profits.

X & Y Co has collected the following information from its own records and the records of Agent Limited

(1)	Confirm and let me have full details if the company has paid commission to Master Limited in previous year(s).	**Yes** **$150,000 in 2011/2012.**
(2)	Let me have copies of documentary evidence to support your client's claim that the purchaser was introduced and referred by Master Limited in Japan. Let me have English translation if the documents were in Japanese.	**No** **Contact was by phone.**
(3)	Confirm whether the purchaser was physically in Japan when the instruction for purchase was given and explain how the execution of the provisional agreements for sale and purchase, the Sale and Purchase Agreements and Deeds of Assignment, were arranged.	**Yes** **By courier** **Client visited HK in October 2012 and returned to Japan to arrange funding etc.**
(4)	Confirm whether the company has any business establishment outside Hong Kong.	**No**

(5)	Let me have a full list of the work done by the company for earning the commission income.	**The company's staff accompanied the client to visit the property and helped to negotiate the price.**
(6)	Let me have a full list of the work done by Master Limited in Japan for the commission of $300,000.	**It provided advice on the Hong Kong property market and contacted potential property buyers.**
(7)	Explain the basis of the commission paid to Master Limited and provide copy of the service agreement, if any.	**50:50. Written agreement not found due to lapse of time.**
(8)	Explain how the commission expenses were incurred in the production of assessable profits.	**Production of commission income.**

Required

Based on information available, prepare a draft reply to the letter from the IRD.

Solution

Based on information available, a draft reply is prepared by the staff of X & Y Co as follows.

(Draft)

The Commissioner of Inland Revenue
G.P.O. Box 132
Hong Kong

(Our Ref.)

Dear Sir/Madam,

XXXX Limited

(File No.)

Profits Tax – Year of Assessment 2012/13

On behalf of the captioned client, we set out our reply below in response to your letter dated XX.

Commission expenses $300,000:

(1) The recipient, Master Limited, is the holding company of our client. There was a similar payment of commission ($150,000) to Master Limited in the year of assessment 2011/2012.

Details of the commission payment in 2011/2012 are as follows:

In January 2012, a purchaser from Japan was introduced by Master Limited to our client to acquire a property at $30,000,000. Our client received commission income of $300,000 from that purchaser and $300,000 from the vendor. Commission of $150,000 was then paid to Master Limited with regard to the services provided.

(2) Our client was advised by Master Limited by phone that there was a potential purchaser from Japan, hence there is no documentary evidence.

(3) The purchaser visited the premises in October 2012 and returned to Japan to arrange for funds. When the instruction for purchase was given to our client, the purchaser was physically in Japan.

The Provisional Agreements for Sale and Purchase, Sale and Purchase Agreements and Deeds of Assignment were sent to the purchaser in Japan for signature by courier.

(4) We confirm that our client does not have any establishment outside Hong Kong.

(5) Our client contacted the potential purchaser in Japan by phone to obtain an understanding of his needs. Several premises were recommended to the purchaser and he finally chose to visit one. Our client accompanied the purchaser to visit the premises in October 2012 three times. Originally, the price requested by the vendor was $65,000,000. Our client conducted lengthy

negotiations with the vendor to persuade him to accept the price offered by the purchaser. With advice from our client, the price was finally agreed at $60,000,000.

(6) Master Limited is a well-established company in Japan. It knows a lot of potential purchasers in Japan who are interested in Hong Kong properties. Advice is provided to these potential purchasers on the investment potential of the properties in Hong Kong. When the potential purchasers express a keen interest in Hong Kong properties, referral will be made to our client. Master Limited also provides our client with the background information and particular interest of the potential purchasers to assist our client to identify the properties that should be marketed.

(7) Our client has agreed to pay half of the commission obtained from the clients referred by Master Limited as commission to Master Limited for services provided. Due to lapse of time, our client is unable to locate a copy of the agreement between the companies. A copy of our client's Board minutes approving the payment is enclosed for your reference. Our client advises that the arrangement is the same as that in 2011/2012.

(8) Master Limited has assisted our client to solicit potential property purchasers from Japan. The commission expenses paid to Master Limited were necessarily incurred in the production of our client's commission income.

In view of the above, we look forward to receiving your agreement to our client's 2012/13 profits tax return.

Yours faithfully,

X & Y Co

cc XXXXLimited (i.e. the client)

5.2 Lodgement of objections against incorrect assessments

There are time limits for objections and appeals . Tax representatives have to draft the grounds for the objections (or appeals) and to seek client’s approval for lodging the objections and appeals within the specified time limits. Under s.64(1) of the IRO, an objection letter has to be lodged with the Commissioner within one month after the date of the notice of assessment. If the assessment is raised under s.59(3), i.e. in the absence of a return, the taxpayer will need to file a valid return to support the objection. The Commissioner may accept a late objection if he is satisfied that the taxpayer is prevented from giving the notice of objection within the time limit by reason of sickness, absence from Hong Kong or other reasonable cause.

The following is an example of an objection letter.

Example: Draft objection letter

Background information

Mr Tommy Kwok acquired a property for $3 million in April 2012. The property was let to an expatriate at monthly rent of $10,000 in May 2012. In January 2013, the property was sold for $3.5 million. The IRD raised enquiries on Mr Tommy Kwok and issued a composite tax return for 2012/13 to him. Tommy completed the return by stating 'nil' profit in it. However, he still received a profits tax assessment dated 1 August 2013.

Required

On behalf of Mr Tommy Kwok, prepare an objection letter to the IRD.

Solution

(Draft)

The Commissioner of Inland Revenue
G.P.O Box 132
Hong Kong
(Our Ref.)

Dear Sir/Madam,

Mr Tommy Kwok
Profits Tax
(File No.)

Objection: Year of Assessment 2012/13

On behalf of the captioned client, we hereby object to the 2012/13 profits tax assessment dated 1 August 2013 in accordance with s.64(1) of the Inland Revenue Ordinance.

Our grounds for objection are as follows:

(1) The assessment is excessive.
(2) Our client had not carried on any business in Hong Kong.
(3) The gain on disposal of the property at (address) was capital in nature.

Pending determination of the objection, we request that the tax in dispute, $75,000, be held over unconditionally.

We look forward to receiving your holdover notice on or before 31 October 2013, being the due date for payment of the tax demanded.

Yours faithfully,

X & Y Co

cc Mr Tommy Kwok

Note. This objection letter needs to reach the IRD on or before 1 September 2013, i.e. one month after the issue of the notice of assessment.

The IRD may raise further enquiries after acknowledging the receipt of the objection. The following is an example of a reply to the IRD's enquiry under s.64(2).

Example: Further enquiry from IRD

Background information

After Mr. Tommy Kwok had objected to the profits tax assessment, he received an enquiry letter dated 1 September 2013 from the IRD under s.64(2) asking for information as follows:

Re: Property at 4/F., Block 10, City One, Shatin, N.T. ('the Property'):

(1) Circumstances leading to the acquisition of the Property.
(2) Whether a feasibility study had been conducted before the acquisition of the Property.
(3) The funding of the purchase money.
(4) The use of the Property.
(5) Circumstances leading to the disposal of the Property.
(6) The use of the sale proceeds.
(7) An account showing the net gains from disposing of the Property.

Mr. Tommy Kwok has provided you with the following information.

- The property was acquired for investment purpose. Sources of funds include his own savings of $2 million and a loan of $1 million from Bank X (repayable by 120 monthly instalments of $12,000).
- The property was let to an expatriate tenant from France after being fully furnished.

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- There was no feasibility study. Tommy considered he should be able to hold the property long-term as the income of his family in 2012 was in the range of $30,000 to $40,000.
- The disposal of the property was due to certain unpleasant contacts with the expatriate tenant. There were complaints such as the malfunction of certain electrical appliances or minor leakage from aluminium windows after rain. As the tenant spoke English with a heavy accent, Tommy was frustrated from dealing with the tenant.
- The property was disposed of with existing tenancy, through a property agent.
- The balance of the sale proceeds (after repayment of the outstanding mortgage loan) has been placed in fixed deposits with Bank Y.

Required

On behalf of Mr. Tommy Kwok, prepare a reply to the IRD's enquiry letter.

Solution

(Draft)

The Commissioner of Inland Revenue
G.P.O. Box 132
Hong Kong (Our Ref.)

Dear Sir/Madam,

Mr. Tommy Kwok
Profits Tax
(File No.)

Objection: Year of Assessment 2012/13

On behalf of our above named client, we thank you for your letter dated 1 September 2013 and reply as follows:

(1) Our client acquired the property in April 2012. By that time, our client had savings of about HK$2 million and was of the view that property investment would generate a steady income in the long run.

(2) Our client was not a sophisticated investor and had not conducted any feasibility study. However, our client had carefully evaluated his family income and was of the view that he could afford the mortgage loan repayments even if there were rent collection problems with the tenant. We would advise that our client's monthly family income in 2012 was in the range of $30,000 to $40,000 while the monthly mortgage loan repayment was $12,000.

(3) A mortgage loan of $1 million was obtained from Bank X. The loan was repayable by monthly instalment of $12,000 for ten years. The balance of the purchase money was from our client's own savings.

(4) After fully furnishing the property (which was essential to expatriate tenants), our client immediately let the property to an expatriate at a monthly rent of $10,000 in May 2012. The property had been held by our client for rental income from 1 May 2012 to the date of disposal.

(5) Our client advises that he had let out the property to a tenant from France. Although he had no problems in collecting the rent from the tenant, he was annoyed with the tenant's frequent requests and complaints, such as the malfunction of certain electrical appliances or minor leakage from aluminium windows after rain. Our client found it difficult to communicate with the tenant because the tenant spoke English with a heavy accent. After several unpleasant contacts with the tenant, our client was frustrated and wished to get rid of the troubles of letting the premises. The property was therefore disposed of in early 2013, with existing tenancy, through a property agent.

(6) Our client advises that the balance of the sale proceeds (after repayment of the outstanding mortgage loan) has been placed in fixed deposits with Bank Y.

(7) An account showing the net gains from the disposal of the property is attached for your reference (please see Appendix 1).

From the above circumstances, it is clear that our client never had any intention to participate in property trading. The property was acquired by our client for long-term investment. When our client subsequently found it unwise and time-consuming to keep that burdensome investment, he decided to dispose of it, even at a less favourable price as the property was not in vacant possession.

In view of the foregoing, we submit that the gain on disposal of the property was capital in nature, which should be excluded from tax pursuant to s.14 of the Inland Revenue Ordinance.

We look forward to your agreement to the objection.

Yours faithfully,

X & Y Co

cc Mr Tommy Kwok

If the IRD refused to allow the objection, the tax representatives may need to lodge an appeal to the Board of Review under s.66 of the IRO against the Commissioner's Determination. The Notice of appeal will have to be filed with the Clerk to the Board of Review within one month after the Notice of the Commissioner's Determination.

An example of a notice of appeal under s.66 is shown in s.7.3.

5.3 Lodgement of s.70A claim to correct an error or omission in a tax return or statement

When there is an error or omission in a tax return or statement, an application under s.70A may be lodged with the IRD within six years after the end of a year of assessment or within six months after the date on which the relative notice of assessment was served, whichever is the later.

The following is an example of a s.70A claim.

Example: s.70A claim

Background information

Mr Tommy Kwok has just uncovered that he had wrongly stated his income of $267,000 as $276,000 in the 2012/13 property tax return.

Required

On behalf of Mr Tommy Kwok, draft an application letter (under s.70A of the IRO) to the IRD.

Solution

(Draft)

The Commissioner of Inland Revenue
G.P.O. Box 132
Hong Kong

(Our Ref.)

Dear Sir/Madam,

Mr Tommy Kwok
Property Tax
(File No.)

Year of Assessment 2012/2013

On behalf of our above named client, we refer to the property tax return for 2012/2013 and would like to advise that, due to an unintentional oversight, our client had wrongly stated his rental income of $267,000 (ie $22,250 × 12) as $276,000 in the return.

We submit a copy of the tenancy agreement showing monthly rent of $22,250 to support our client's claim.

We shall be grateful if you will correct the error pursuant to s.70A of the Inland Revenue Ordinance and refund the tax overpaid of $XXX to our client in due course.

Yours faithfully,

X & Y Co

cc Mr Tommy Kwok

Note. The latest submission date for this application letter is 31 March 2019 (i.e. six years after the end of the year of assessment 2012/2013).

5.4 Submission of holdover application for provisional profits tax

An application for holdover of provisional profits tax may be made in any one of the following circumstances:

- assessable profits for the year are likely to be less than 90% of the provisional amount assessed;
- a loss brought forward has been omitted or is incorrect;
- cessation of trade, profession or business and the assessable profits for the year are less than the estimated amount;
- an objection has been lodged against the final assessment upon which the provisional assessment is based; or
- for persons other than a corporation, election for personal assessment has been made which is likely to reduce the tax liability.

The application for holdover of provisional tax should be in writing. It should be submitted to the Commissioner not later than:

- twenty-eight days before the payment due date; or
- fourteen days after the date of the notice for payment of provisional tax;

whichever is the later.

Unlike an objection, the Commissioner does not have any discretionary power to entertain a late application for holdover. If the taxpayer is unable to submit the holdover application as there is less than twenty-eight days before the first instalment due date, he may consider to settle the first instalment in full and then submit an application to holdover the second instalment. It should be noted that if the first instalment were not paid on or before its due date, the second instalment would become immediately payable and the IRD may impose a surcharge on the total of the outstanding tax.

If the company applies for a holdover of provisional profits tax on the grounds that its assessable profit for the year of assessment is likely to be less than 90% of the provisional amount assessed, the IRD will require the company's latest management accounts to be certified by its director as supporting evidence. In practice, the IRD usually requests the taxpayer to submit management accounts for at least eight months as supporting documents for the holdover.

The following is an example of a holdover application letter.

Example: Draft holdover application letter

Background information

XYZ Securities Limited received a profits tax assessment for 2011/12 (final) and 2012/13 (provisional) issued on 1 September 2012 with payment due dates on 1 February 2012 and 1 May

2013. The company suffered a loss of $500,000 for the period ended 31 October 2012 and decided to cease business by the end of December 2012.

Required

On behalf of XYZ Securities Limited, draft a holdover application letter to the IRD.

Solution

(Draft)

The Commissioner of Inland Revenue
G.P.O Box 132
Hong Kong

(Our Ref.)

Dear Sir/Madam,

XYZ Securities Limited
(File No.)

Holdover Application for Provisional Profits Tax for 2012/13

We have been instructed by our client to make an application under the provisions of s.63(J) of the Inland Revenue Ordinance, for a holdover of the provisional profits tax for 2012/13.

Our client's grounds for making this application are that they have incurred a loss of $500,000 for the period ended 31 October 2012 and decided to cease business on 31 December 2012.

We therefore request the provisional profits tax for 2012/13 amounting to (amount) be held over. In support of our application, we enclose for your attention a copy of our client's management accounts for the period ended 31 October 2012 duly signed by a director.

We look forward to receiving your confirmation that the holdover has been granted on or before 1 February 2013, being the due date for payment of the tax demanded.

Yours faithfully,

X & Y Co

cc XYZ Securities Limited

6 General tax advisory services by tax representatives

Topic highlights

Demand for tax advisory services increases as tax laws become more and more complex with the enactment of anti-avoidance provisions from time to time.

Typical tax advisory services provided by tax representatives include:

- group restructuring
- acquisitions and mergers
- pre-listing reviews
- buy or lease transactions (e.g. leveraged leasing)
- financial arrangements (e.g. obtaining a secured bank loan, issue of debentures)

For large group mergers or restructuring, tax advisory services often involve tax knowledge of more than one jurisdiction and firms with an international network are likely to have a competitive advantage. Since acquisitions, mergers, listings, group restructuring or buying a capital asset will affect the structure of the business enterprise, the advisory fees are therefore of a capital nature and not deductible for tax purposes. On the other hand, advisory fees on short term financing

arrangements (including a lease) are generally allowable as the arrangements will only have a temporary impact on the business and the fees are likely to recur.

To avoid misunderstanding, tax advisors should also issue tax engagement letters to clients specifying clearly the scope of the tax advisory work.

In essence, a tax advisor should communicate effectively with both the clients and the IRD. Although the IRD may have a different view from that of the tax advisor, in general, tax representatives seldom have communication problems with the IRD. On the other hand, tax advisors may find it difficult to explain complex tax issues to clients who have little tax knowledge.

In explaining a tax issue to a client, it is important for the tax advisor to avoid technical jargon (e.g. 'situs' of an asset). The tax advisor needs to consider the background of the client (whether the client has any accounting and tax knowledge) in order to find the right words to explain a tax issue to him. If there is no indication that the client has in-depth tax knowledge, the tax advisor should use plain language (e.g. location of an asset) to explain a tax issue. Examples and diagrams will also help clients understand complex tax issues.

If the advice is in writing, the tax advisor needs to ensure that the technical aspect is relevant and accurate. It is also important to ensure that the client is put at ease in reading the advice letter. The advice letter is a means of communication between the tax advisor and his clients. Technical jargon, long sentences or paragraphs will be difficult to read or understand and should be avoided. Examples and diagrams should be used to elaborate complex issues.

The following is an example of an advice letter on the Hong Kong tax issue of stock options.

Self-test question 1

Background information

Mr. R, the Financial Controller of an international group of companies, raised a few questions by email dated February 1, 2012 on issuing stock options to staff of a Woodstock subsidiary ('the Company') working in Hong Kong.

He outlines the following background information:

1. Holders of stock options under the Woodstock Holdings Limited 2011 Unapproved Share Option Plan (Option Plan) are likely to exercise their options at the time an offer for the Company by Snopie plc to be made on 10 November 2011 becomes unconditional. The financial effects of the option holders are as follows:

   Under the Option Plan, they will purchase shares for $1.20 per share which will have a value of $3.00 per share, thus acquiring the shares at a discount of $1.80 per share.

2. The timing of these option exercises will depend on when Snopie's offer becomes unconditional and is anticipated to be any time between 1 December 2011 and 9 January 2012

3. It is likely that the option holders will sell the shares acquired for $3.00 per share, by late January or in February 2012.

Questions raised

1. The total tax/social security (if any) which the Company will be required to pay on each option holder's behalf (a table showing option gains for each person under the Option Plan (assuming they each exercise in full) is/will be supplied).

2. When the Company will be required to pay any such tax/social security to the tax authorities concerned. We realise this may depend on when the options are exercised, but perhaps you could confirm some general principles for any link between the time of exercise of option and obligation on the company to pay any resulting tax/social security.

3. Whether there are any other taxation obligations on the Company arising from the exercise of options or the sale of the resulting shares by or on behalf of option holders.

Required

Draft an advice letter to Mr R.

(The answer is at the end of the chapter)

7 Special tax advisory services by tax representatives

Topic highlights

Special advisory services provided by tax representatives include:

- application for advance rulings;
- tax investigation and field audit;
- appeal to the Board of Review under s.66 against a determination by the Commissioner;
- appeal to the Board of Review under s.82B against an additional tax assessment raised by the Commissioner or the Deputy Commissioner under s.82A.

Note: Taxpayers are usually legally represented in appeals to the courts (i.e. appeals beyond the Board of Review).

7.1 Application for Advance Rulings

Pursuant to s.88A of the IRO, a taxpayer may apply for a ruling on the way in which a provision of the IRO applies to the taxpayer and to any particular arrangement.

The application is to be made on Form IR1297 , Application for Advance Ruling, together with other relevant information and supporting documents.

The tax representatives may prepare all the required documents (e.g. a draft ruling) for the taxpayer and submit the request for an advance ruling to the Deputy Commissioner of Inland Revenue (Technical) together with a written authorisation from the taxpayer and the specified application fee ($10,000 or $30,000).

The IRD may refuse to grant a ruling or it may request further information before granting the ruling. Further fees ($1,000 - $1,330 per hour or part hour spent by the IRD officer) may have to be paid.

The costs paid to the IRD for the advance ruling and the fees paid to the tax representatives in preparing all the supporting documents could be substantial, especially as:

- the ruling may not be granted by the IRD;
- the ruling may be granted by the IRD but withdrawn later; or
- the ruling is valid for no more than two years.

DIPN No. 31 provides guidance on the application for advance rulings.

The IRD has published a number of rulings cases in its website. Please refer to **http://www.ird.gov.hk/eng/ppr/arc.htm** for information.

7.2 Tax Investigation and Field Audit

The services generally provided by tax representatives in tax investigation and field audit cases are outlined in chapter 10, Tax Investigation and Field Audit

7.3 Appeal to the Board of Review under s.66 against a determination by the Commissioner

Before an appeal is lodged with the Board of Review under s.66 of the IRO, the strengths and weaknesses of the case should be carefully scrutinised. Clients should be reminded that the onus of proof before the Board of Review is with the taxpayer and the burden of proof is heavy. They should also be alerted to the fact that the Board of Review has the power to increase (not just confirm or reduce) the tax liability or to grant an order for costs (not exceeding $5,000) to the Board if the assessment is neither reduced nor annulled after the appeal (i.e. the Board considers that the appeal is without merit).

The notice of appeal has to be submitted to the Clerk to the Board of Review within one month from the date of the Commissioner's determination although the Board may accept a late appeal if the appellant was prevented by illness or absence from Hong Kong or other reasonable cause from lodging the appeal in time.

The following is an example of a brief analysis of the strengths and weaknesses of a case and a notice of appeal under s.66 of the IRO.

Example: Case assessment

Background information

See 5.2 (Mr. Tommy Kwok).

Required

Identify the strengths and weaknesses of the case of Mr. Tommy Kwok.

Solution

The strengths of the case include:

- Mr. Tommy Kwok had sufficient funds (savings and income) to hold the property for long term.
- The property was let soon after it was acquired (i.e. consistent with the declared investment intention).
- The property had been held for rental purpose before its disposal.
- Mr. Tommy Kwok had no property trading records.
- There were unexpected circumstances leading to the disposal of the property.

The weaknesses of the case include:

- Short period of ownership.
- No feasibility study on rental return.
- Property agent was appointed to solicit a purchaser.

The Clerk to the Board of Review will then fix a date (or dates) for the hearing. The hearing will be in camera (i.e., not open to the public). The Board's finding on the facts will be final.

Although the taxpayer does not need to be legally represented before the Board of Review, the costs associated with an appeal could still be substantial. These include the costs of agreeing the Statement of Facts with the IRD before the Board hearing, preparation work before the Board hearing (e.g. conducting research on judicial precedents to be cited before the Board, preparation of the submission to the Board, etc.), the appearance of the tax representatives before the Board and bundles of supporting documents. Such appeal costs are not tax deductible as they are not incurred in the production of assessable profits.

The creditworthiness of the witness (or witnesses) before the Board of Review is important. The witness should be creditable and dependable and should be able to address the issues of the case in a logical and consistent manner before the Board of Review.

The self-test question below asks the student to draft a notice of appeal to the Board of Review.

Self-test question 2

Required

On behalf of Mr. Tommy Kwok, draft a notice of appeal to the Board of Review.

(The answer is at the end of the chapter)

During the Board hearing, the tax representatives will examine the witness on the facts of the case. The IRD representatives will then cross-examine the witness and challenge any inconsistency in his or her evidence. Finally, the tax representatives will have the chance to re-examine the witness to clear any ambiguity and seek to re-establish the confidence of the witness. From time to time during the hearing, the Chairperson and members of the Board will also raise queries on the witness. The tax representatives will assist the witness to understand the issues of the queries. However, the tax representatives are not allowed to answer the questions on behalf of the witness.

After all the witnesses are examined, the IRD representatives and the taxpayer's representatives will make submissions (oral and/or written) to the Board of Review. The Board will consider the arguments from both sides in making its determination.

7.4 Appeal to the Board of Review under s.82B against an additional tax assessment raised by the Commissioner or a Deputy Commissioner under s.82A

A taxpayer may be charged to additional tax under s.82A for:

- no return;
- late return;
- incorrect return (e.g. back duty investigation, omission of income); or
- failure to inform the Commissioner of his or her chargeability for tax.

An appeal may be lodged to the Board of Review under s.82B against an additional tax assessment if:

- there is a reasonable excuse for the offence;
- the additional tax exceeds the maximum amount allowed under s.82A; or
- the additional tax is excessive having regard to the circumstances.

The notice of appeal should be in writing to the Clerk to the Board of Review and be accompanied by:

- a copy of the notice of additional tax assessment;
- a statement of the grounds of appeal;
- a copy of the notice of intention to assess additional tax given by the Commissioner or a Deputy Commissioner under s.82A(4), if any such notice was given; and
- a copy of any written representations made under s.82A(4).

The time limit for lodging the appeal is one month after the notice of assessment of additional tax is given. For any s.82A notice of assessment given on or after 25 June 2004, the Board of Review may extend the time limit for an appeal under s.82B as it thinks fit if it is satisfied that the appellant was prevented by illness or absence from Hong Kong or other reasonable cause from giving the notice of appeal within the one-month period.

The following is an example of a notice of appeal against an additional tax assessment for an incorrect return relating to omission of income.

Example: Appeal against additional tax assessment

Background information

Ms. Amy Cheung did not report her income of $200,000 from Company A in her individual tax return for 2010/11. The Deputy Commissioner issued her a notice under s.82A(4) in August 2011. She made representations that the omission was caused by an innocent mistake. On 1 October 2011, the Deputy Commissioner raised an additional tax of $10,000 under s.82A, being 25% of the tax that would have been undercharged should the omission not be discovered.

In fact, Ms. Cheung had declared the income from Company A when she applied for a holdover of the provisional salaries tax payable in October 2010 (ie when she left Company A). She had submitted a copy of the *Employer's Return on Cessation of Employment* (Form IR 56F) showing the income of $200,000 in the holdover application letter. The IRD held over the provisional salaries tax as requested by her. After paying the tax after the holdover, Amy had a wrong impression that the tax on the income of $200,000 had been cleared. Such income was therefore not included in the 2010/11 tax return, which was completed by Amy in May 2011, some eight months after the holdover application.

Required

On behalf of Ms. Amy Cheung, prepare a notice of appeal against the additional tax assessment.

Solution

(Draft)

Clerk to the Board of Review
1/F, Low Block
Queensway Government Offices
66 Queensway
Hong Kong

(Our Ref.)

Dear Sir/Madam,

Ms. Amy Cheung
(File Reference)

Appeal Against Additional Tax Assessment – Year of Assessment 2010/11

On behalf of our above client, we would like to lodge an appeal under s.82B of the Inland Revenue Ordinance against the additional tax assessment raised by the Deputy Commissioner on 1 October 2011.

Our grounds of appeal are as follows:

(1) Our client is not chargeable for additional tax as she has a reasonable excuse for the omission of the income of HK$200,000; or, alternatively,

(2) The additional tax of HK$10,000 is excessive having regard to the circumstances in our client's case.

In support of our appeal, we enclose the following documents:

(1) Copy of the Deputy Commissioner's notice under s.82A(4).
(2) Copy of our client's representations.
(3) Copy of the notice of additional tax assessment dated 1 October 2011.

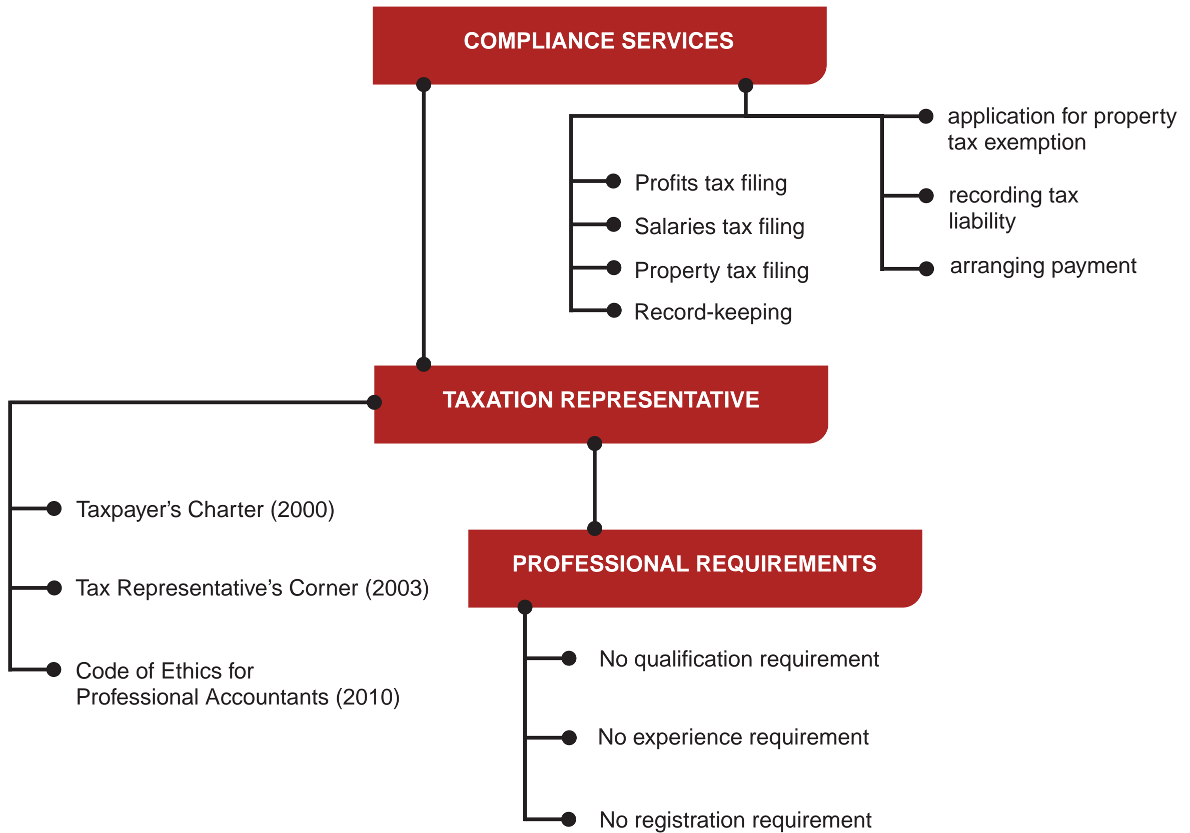
Yours faithfully,

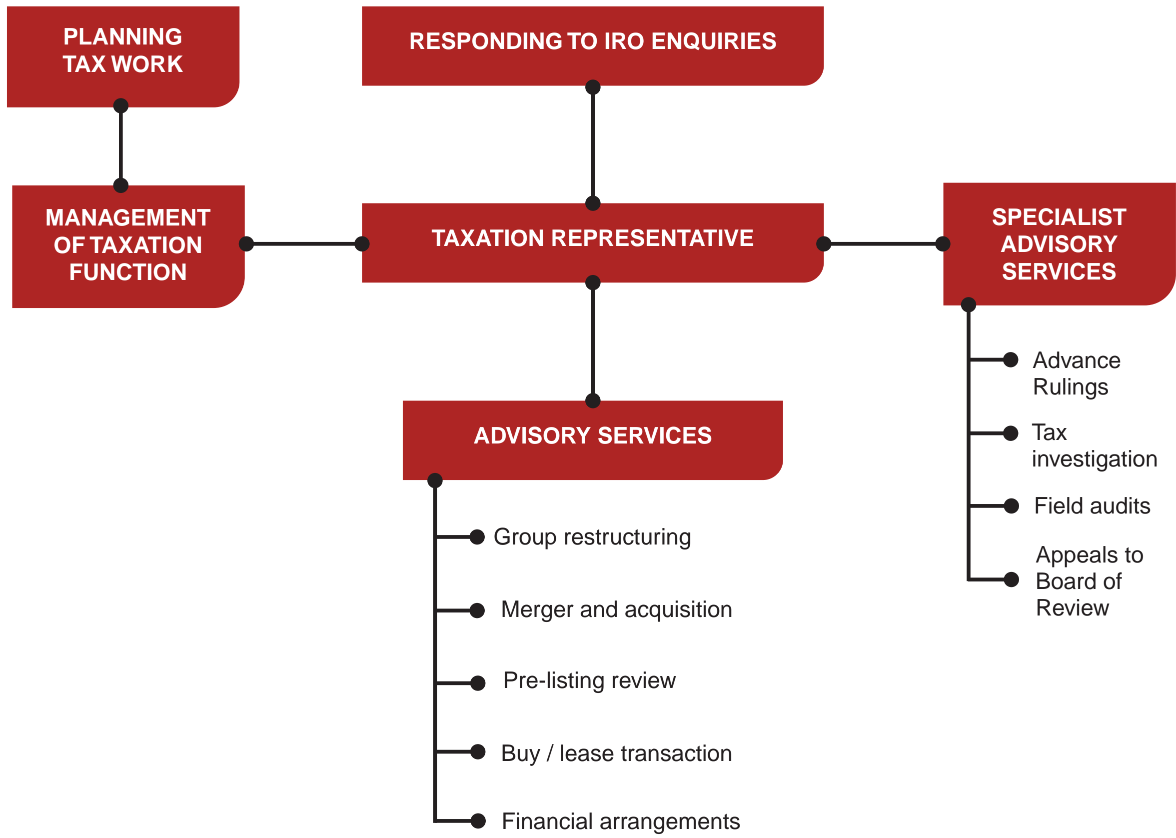
X & Y Co

cc Ms. Amy Cheung
cc The Commissioner of Inland Revenue

The Clerk to the Board of Review will fix a date (or dates) for the hearing. The hearing will be similar to that under s.66. Ms. Amy Cheung should prepare for being examined by the IRD representatives and the Chairperson and members of the Board of Review.

Topic recap




PLANNING TAX WORK
RESPONDING TO IRO ENQUIRIES
MANAGEMENT OF TAXATION FUNCTION
TAXATION REPRESENTATIVE
SPECIALIST ADVISORY SERVICES
Advance Rulings
Tax investigation
Field audits
Appeals to Board of Review
ADVISORY SERVICES
Group restructuring
Merger and acquisition
Pre-listing review
Buy / lease transaction
Financial arrangements

Answers to self-test questions

Answer 1

(Draft)

Mr. R
(Company name)
(Address)
(Our Ref.)

Dear Mr. R,

We refer to your email dated February 1, 2012 regarding the Hong Kong tax implications on exercising of certain stock options issued by a Woodstock's subsidiary company (the Company) to potential option holders in Hong Kong. We summarise below our understanding and comments for your information:

Our understanding

1 Holders of options under the Woodstock Holdings Limited 20110 Unapproved Share Option Plan (Option Plan) are likely to exercise their options at the time an offer for the Company by Snopie plc to be made on 10 November 2011 becomes unconditional. The financial effects of the option holders are as follows:

- Under the Option Plan, they will purchase shares for $1.20 per share which will have a value of $3.00 per share, thus acquiring the shares at a discount of $1.80 per share.

2 The timing of these option exercises will depend on when Snopie's offer becomes unconditional and is anticipated to be any time between 1 December 2011 and 9 January 2012.

3 It is likely that the option holders will sell the shares acquired for $3.00 per share, by late January or in February 2012.

Issues raised

1 The total tax/social security (if any) which the Company will be required to pay on each option holder's behalf (a table showing option gains for each person under the Option Plan (assuming they each exercise in full) is/will be supplied).

2 When the Company will be required to pay any such tax/social security to the tax authorities concerned and some general principles for any link between the time of exercise of option and obligation on the company to pay any resulting tax/social security.

3 Whether there are any other taxation obligations on the Company arising from the exercise of options or the sale of the resulting shares by or on behalf of option holders.

Our comments

Hong Kong Salaries Tax implications

In general, stock option is a form of benefit given to an employee by his/her employer. The benefit, if derived from Hong Kong, will be subject to Hong Kong Salaries Tax when the stock options are exercised. The following are points to note regarding the taxability of stock options in Hong Kong:

- The taxable amount for any stock options gains will be the difference between the cost to the employee in exercising the options and the total market value of the stocks granted.
- If the options were exercised when the exercise price is higher than the market value, no tax deductions will be allowed.

- Any gain or loss from the subsequent disposal of the stocks would normally be treated as capital in nature and have no tax implications to the employees.
- Even if the shares were not disposed of immediately after being exercised, any gains on exercising the options will need to be reported and tax be paid in the same year. There are no tax concessions if subsequent losses on disposal of the shares are suffered.
- Stock options are taxed in the same manner as any other salary income.
- For stock options granted based on services rendered wholly in Hong Kong, the gain on exercising the stock options will be taxable, irrespective of whether the rights are issued in the shares of the local employer company or its overseas affiliates.
- For stock options granted based on services rendered wholly outside of Hong Kong, any gain on exercising the options would not normally be subject to Hong Kong salaries tax.
- For stock options granted based on a foreign employment where services are rendered both in and outside of Hong Kong, any gain on exercising the options would be subject to tax based on a time apportionment basis.
- More complex situation will occur where the stock options are issued conditionally, e.g. subject to a vesting period, during which part of the services were rendered outside of Hong Kong and part in Hong Kong.
- The employer is obliged to notify the Inland Revenue Department when stock options are granted or exercised and the employees need to report to the Inland Revenue Department on any gains derived from exercising the options. Departure from Hong Kong would not preclude any potential tax liabilities on stock options gains. Taxpayers departing from Hong Kong can elect to be taxed on the notional gains on exercising the options. Heavy penalties may be imposed on non-compliance.
- Care should be taken that stock options gains may trigger foreign taxes depending on the individual's circumstances. Foreign taxes paid may not necessarily be allowed to offset Hong Kong tax and vice versa.
- Hong Kong Salaries Tax is charged either at a progressive rate or standard rate, whichever is lower. For calculation simplicity, the standard tax rate of 15% for the year of assessment 2011/12 is adopted.

Based on the above, the Hong Kong Salaries Tax implications on the option holders will be as follows:

Option Plan

Upon exercising the options, the option holder will be taxed at the difference between the market value i.e. $3.00 per share less the exercising price, i.e. $1.20 per share. Hence, the discount of $1.80 per share will be considered as an employment income subject to Hong Kong salaries tax. As the exercising of the options will take place within the year of assessment 2011/12, the income will have to be reported by a holder as part of his/her employment income in the individual's Income Tax Return in the same year. Tax charged on this income will normally be due sometime in December 2012 to April 2013.

Assuming the gain is wholly taxable in Hong Kong, the tax liabilities per share thereon will be calculated as follows:

$1.80 × 15% = $0.27 per share

Capital gains

Capital gains are not taxable in Hong Kong. Hence, upon disposal of the shares by the individuals, any gains derived thereon will not be subject to Hong Kong Tax. However, if capital loss is incurred, the loss cannot be used to offset any income previously declared as part of employment income on exercising the options.

Other issues

1 If the option holders of the Option Plan are under foreign employment albeit based in Hong Kong, the gains from the granting of shares or exercising the options may be apportioned based on the time spent outside of Hong Kong and taking into account the overall vesting period of the options granted.

2 We understand that the shares may be disposed of by the employing company on behalf of the individual option holders. Nonetheless, the tax liabilities lie with the option holders and the individual option holders are obliged to report the income on their tax returns and pay the tax thereon. If the Company will pay the tax on behalf of the individuals, the tax so paid will be considered as taxable income to the individuals.

3 Hong Kong does not have a pay-as-you-earn or withholding tax system.

4 While there is no tax liability for the employing company, the employing company is expected to have reported the granting of the stock options in the year of granting. In addition, the Company is obliged to report the subsequent exercising of the options in the annual employer's return which will be due sometime in May 2012. Failure to do so may attract penalty imposed by the Inland Revenue Department.

5 If the Company has awarded any share benefits to the Employees, the tax treatment of such will depend on when the employees will be entitled to the shares. Where vesting period is imposed as a condition to the entitlement, the value of the shares will only be considered as employment income to the employees when the vesting period conditions are fulfilled.

Conclusion

The above provides a general guideline on the taxability of stock options in Hong Kong. The tax implications on each individual will be determined by their specific circumstances. We will be pleased to assist the Company and/or the individual employees in determining their tax liabilities or handle the tax compliance in the forthcoming year of assessment should this be required.

We trust the above will be of assistance to you. Should you have any further questions, please do not hesitate to contact Mr. A, Tax Manager of this office, on (telephone number) or me on (telephone number).

Yours sincerely,

Partner

A & B Co

Answer 2

(Draft)

Clerk to the Board of Review
1/F., Low Block
Queensway Government Offices
66 Queensway
Hong Kong
(Our Ref.)

Dear Sir/Madam,

Mr. Tommy Kwok

(File Reference)

Notice of Appeal – Year of Assessment 2012/13

We refer to the Commissioner's Determination dated (date) on the objection against the profits tax assessment for the year of assessment 2012/13. On behalf of our client, we hereby give you notice of appeal to the Determination in accordance with s.66(1) of the Inland Revenue Ordinance on the following grounds:

1. The profits assessed are excessive.
2. The gain on disposal of the property at 3/F., Block 10, City One, Shatin, N.T. is of a capital nature and should not be subject to Hong Kong profits tax.

A copy of the Commissioner's Determination dated (date) together with the Statements of Facts and Reasons are enclosed for your reference.

Yours faithfully,

A & B Co

cc. Mr. Tommy Kwok

cc. The Commissioner of Inland Revenue

Exam practice

Mr. Lee

18 minutes

You are the tax manager of ABC & Company, CPA. One of the clients handled by you is Mr. Lee. Mr. Lee has set up an offshore operation last year with some contemplated tax scheme. He seeks your advice on the offshore claim that his company may lodge in Hong Kong. He wishes to understand the mechanism provided under the Inland Revenue Ordinance with respect to ascertaining the possibility of an offshore profits claim.

Required

Advise Mr. Lee how he can be certain of the offshore profits claim. **(10 marks)**

D Limited

27 minutes

D Limited is a garment manufacturer for many US and European brands. During the year ended 31 December 2008, a US brand ('the Brand') terminated its manufacturing contract with D Limited, which accounted for 15% of the latter's turnover. After negotiation, the Brand agreed to compensate D Limited with a sum of HK$20,000,000 ('the Compensation'). The Compensation was decided with reference to the profits which D Limited would have derived during the remaining period of the contract.

Owing to the above termination of the manufacturing contract, D Limited closed the relevant production line and laid off 20 workers. The company provided the redundant workers with severance payments of HK$1,200,000 ('the Severance Payment') in accordance with the Employment Ordinance. In the 2008 accounts, D Limited recorded the Compensation as a trading receipt. However, it did not charge the Severance Payment as an expense in its accounts.

Recently, D Limited has received its 2008/09 final tax assessment and 2009/10 demand for provisional tax, both were computed with the returned profits for the year of assessment 2008/09. Mr X, the financial controller, considers the assessments to be excessive because the Compensation and the Severance Payment are not correctly treated. He engages a tax advisory firm, E & Co., to review the matter.

Required:

Assuming that you are a tax manager of E & Co. who is assigned to handle the case of D Limited, draft an advice letter to D Limited analysing:

(a) the taxability of the Compensation;

(b) the deductibility of the Severance Payment; and

(c) the possible actions which D Limited may take to reduce its tax liabilities, and the relevant statutory requirements which the company has to observe in this connection. **(15 marks)**

HKICPA Module D December 2010

Varian Inc. **28 minutes**

Varian Inc. is a company incorporated and carrying on business in the United States in the software development sector. The company did not perform any business in Hong Kong in prior years, but recently the board of directors of the company resolved to extend its scope of business in Hong Kong in the near future by setting up a limited company in Hong Kong (Newco). To facilitate the development of its business activities, Newco's business plan will include the employment of staff in Hong Kong for daily business operations, appointment of local individuals as independent software consultants and the appointment of third party entities as sales agents in Hong Kong.

Required:

Evaluate the Hong Kong Tax compliance obligations and disclosure requirements of Newco. Your answer should include the following matters:

(a) Obligations of taxpayers for doing business in Hong Kong from a profits tax perspective. **(4 marks)**

(b) Obligations of taxpayers as employers. **(5 marks)**

(c) Obligations of taxpayers for engaging local individuals as independent consultants instead of employees to perform software development in Hong Kong. **(4 marks)**

(d) Payment of concealed commission to third parties (identities of the recipients not properly disclosed to the IRD) for the referral of business in Hong Kong. **(3 marks)**

(Total = 16 marks)

HKICPA Module D December 2011

Herbert

Herbert has carried on an insurance agency business on his own account. Three months ago, the IRD informed Herbert that a tax audit would be conducted in respect of his business accounts for the year ended 31 March 2011. Herbert engaged J & Co. to handle the audit.

After examining the relevant accounts and records, J & Co. found that Herbert had omitted from his accounts an initial signing fee received pursuant to his service contract with the insurance company he joined on 1 July 2010. If he terminates his service contract within five years, he would be required to repay a portion of the initial signing fee. In addition, J & Co. failed to locate certain invoices and receipts in relation to the expenses claimed in the accounts.

Required:

Assuming that you are the partner of J & Co., evaluate, from the ethical perspective:

(a) how you will advise Herbert in light of the findings stated in the question; and **(3 marks)**

(b) what you should do if Herbert has made some fictitious invoices and receipts, and asks you to submit them to the IRD to substantiate the expense claims. **(3 marks)**

HKICPA June 2012 Question 8(b)

Dr. A

Discuss the following issues in relation to Dr. A's idea of carrying on his medical practice through Company E:

Required:

What ethical consideration should the accountant be aware of in advising Dr. A on such a tax planning idea? **(5 marks)**

HKICPA Module D December 2012

CPA Hong Kong Institute of Certified Public Accountants 香港會計師公會

Further reading

Suggested References

When studying this topic we suggest the following references:

Primary References

Advanced Taxation in Hong Kong, Pearson (Chapter 7 – Returns and Assessments, Chapter 8 – Objections and Appeals, Disputes to Assessments and Tax Collection, Chapter 21 – Tax Investigation, Offences and Penalties)

Hong Kong Master Tax Guide, CCH Hong Kong Ltd (Chapter 9 – Returns and Information, Assessment, Provisional Tax; Chapter 11 — Objections, Appeals, Chapter 12 – Offences and Penalties)

Hong Kong Taxation – Law & Practice, The Chinese University Press (Chapter 7 — Returns and Information to be Supplied, Penalties, Chapter 8 – Assessments and Payment of Tax, Chapter 9 – Objections and Appeals)

Hong Kong Taxation and Tax Planning, Pilot Publishing Co Ltd (Chapters 2 to 5)

Inland Revenue Ordinance (Parts IX, X, XA, XB, XC, XI, XIV, XV)

Supplementary Reference

Hong Kong Tax Manual, CCH Hong Kong Ltd (Para 25 – Returns, assessment; Para 35 – Objections, Appeals, Offences & Penalties)

chapter 12

Double taxation arrangement and agreements

Topic list

1 Taxation of overseas income
1.1 Airline and shipping income
2 The OECD and Model Tax Treaty
2.1 Role of the OECD Model Tax Treaty
3 Double Taxation Arrangement (DTA) between the Mainland of China and the HKSAR
3.1 DTA between the Mainland of China and the HKSAR
4 Double taxation reliefs
4.1 Relief from double taxation due to transfer pricing adjustment
4.2 Transfer pricing guidelines - methodologies and related issues
4.3 Exchange of information
4.4 Advance Pricing Arrangement
5 Other Double Taxation Agreements
5.1 Avoidance of double taxation agreement between the HKSAR and Belgium
5.2 Avoidance of double taxation agreement between the HKSAR and Thailand
5.3 Avoidance of double taxation agreement between the HKSAR and Luxembourg
5.4 Avoidance of double taxation agreement between the HKSAR and Vietnam
5.5 Avoidance of double taxation agreement between the HKSAR and the Netherlands
5.6 Other double taxation agreements
Appendix
Appendix 1: Summary of Avoidance of Double Taxation Agreements

Learning focus

As of 1 June 2013, Hong Kong has signed 29 comprehensive double taxation arrangements and agreements. Among them all, the most important arrangement is the Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion signed between the HKSAR and the Mainland of China. It is important to be familiar with various important articles and DIPNs. The recent developments in respect of exchange of information should be fully understood.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Taxation of businesses		
2.29	**Arrangement between the Mainland of China and the HKSAR ('the Arrangement')**	3
2.29.01	Explain the various articles and provisions under the Arrangement	
2.29.02	Explain the relationship between the Arrangement and the IRO	
2.29.03	Explain what constitutes a 'resident' in the context of the Arrangement	
2.29.04	Calculate the amount of tax paid and credits under the Arrangement	
2.29.05	Explain the article concerning exchange of information under the Arrangement and its significance	
2.29.06	Explain and apply DIPNs 32, 44 and 47	
2.43	**Double taxation relief**	1
2.43.01	Describe the general purpose and application of double taxation treaties	
2.44	**Hong Kong tax planning**	3
2.44.07	Describe the role of OECD	
2.44.08	Discuss the use of transfer pricing arrangement in tax planning	
2.44.09	Identify the tax planning opportunities under the Arrangement	
2.44.10	Explain and apply DIPN 24, 45, 46 and 48	

1 Taxation of overseas income

Topic highlights

Double taxation arises when a type of income, such as employment income and business profits, may be subject to tax in two or more jurisdictions.

Hong Kong adopts the territoriality basis of taxation, whereby only income or profit sourced in Hong Kong is subject to tax and that derived from a source outside Hong Kong by a local resident is in most cases not taxed in Hong Kong. Therefore, Hong Kong residents generally do not suffer from double taxation.

Many countries which tax their residents on a worldwide basis also provide their residents operating businesses in Hong Kong with unilateral tax credit relief for any Hong Kong tax paid on income or profit derived from Hong Kong.

In addition, Hong Kong allows a deduction for foreign tax paid on turnover basis in respect of an income which is also subject to tax in Hong Kong. Businesses operating in Hong Kong therefore do not generally have problems with double taxation of income.

Notwithstanding this, the Hong Kong Special Administrative Region Government recognises the merits in concluding double taxation agreements ('DTAs') with various other countries. DTAs were made pursuant to s.49 of the IRO. A DTA provides certainty to investors on the taxing rights of the contracting parties; helps investors to better assess their potential tax liabilities on economic activities; and provides an added incentive for overseas companies to do business in Hong Kong, and likewise, for Hong Kong companies to do business overseas. Therefore, Hong Kong has tried to establish a DTA network that minimises exposure of Hong Kong residents and residents of the DTA partner to double taxation. The DTAs are based on the Model Double Taxation Treaties of the Organisation for Economic Co-operation and Development (OECD) and the United Nations.

Due to the international nature of aircraft operations, airline operators are more susceptible to double taxation than other taxpayers. As negotiation of comprehensive DTA may take consideration time, it has been Hong Kong's policy to include double taxation relief arrangements for airline income in the bilateral Air Services Agreements negotiated between Hong Kong and its aviation partners.

Shipping income is another area of concern. The Hong Kong legislation provides a reciprocal tax exemption from 1 April 1998 for shipping income so that ship operators can benefit from the tax relief offered by places with similar reciprocal tax exemption legislation. In parallel, Hong Kong has entered into negotiations of double taxation relief arrangements for shipping income with other places that either do not provide reciprocal tax exemption in their legislation or, even reciprocal exemption provisions exist, prefer conclusion of a bilateral agreement.

There are also agreements that cover both airline and shipping income.

1.1 Airline and shipping income

Hong Kong entered into a double taxation arrangement with the United States of America in 1989 in respect of the taxation of income derived by residents of Hong Kong and the United States from the international operation of ships (not including aircrafts). In November 2003, there was another double taxation agreement on shipping and air services income with Singapore. A similar agreement with Sri Lanka was entered into in November 2004. There are also double taxation arrangements on shipping income with the United Kingdom, the Netherlands, Germany, Norway and Denmark on international shipping income. Shipping income chargeable to Hong Kong Profits Tax by virtue of s.23B(2) are exempted if the owners are resident of Korea or New Zealand, and *vice versa*.

In respect of international aviation income, Hong Kong has entered into double taxation arrangements with Bangladesh, Belgium, Canada, Croatia, Denmark, Estonia, Ethiopia, Fiji,

Finland, Germany, Iceland, Israel, Jordan, Kenya, Korea, Kuwait, Laos (pending order by Chief Executive in Council), Macau SAR, the mainland of China, Maldives, Mauritius, Mexico, the Netherlands, New Zealand, Norway, Russian Federation, Sweden, Switzerland and the United Kingdom.

The Avoidance of Double Taxation on shipping and air services income is also covered by the comprehensive double taxation agreements ('DTAs') signed by Hong Kong Government.

As of 1 June 2013, Hong Kong has signed 29 comprehensive DTAs, including Belgium, Thailand, the Mainland of China, Luxembourg, Vietnam, Brunei, the Netherlands, Indonesia, Hungary, Kuwait, Austria, the United Kingdom, Ireland, Liechtenstein, France, Japan, New Zealand, Switzerland, Portugal, Spain, the Czech Republic, Malta, Jersey, Malaysia, Mexico, Canada, Italy, Guernsey and Qatar.

2 The OECD and Model Tax Treaty

Topic highlights

For the avoidance of double taxation, many countries have entered into tax treaties that are based on the OECD Model and the Model Treaty of United Nations.

The Organisation for Economic Co-operation and Development ('OECD') is an inter-governmental organisation. As of 1 June 2013, OECD has 34 member countries: Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

Exchanges between OECD governments flow from information and analysis provided by a Secretariat in Paris. The organisation is one of the world's largest and most reliable sources of comparable statistical, economic and social data. Parts of the Secretariat collect data, monitor trends, analyse and forecast economic developments, while others research social changes or evolving patterns in trade, environment, agriculture, technology, taxation and more.

Non-members are invited to subscribe to OECD agreements and treaties, and the organisation now involves in its work with more than 70 non-member countries from Brazil, China, India and Russia to least developing countries in Africa and elsewhere.

The OECD is devoted to understand and help governments respond to new challenges such as sustainable development, electronic commerce, biotechnology and food safety, etc. This work underpins discussion by member countries when they meet in specialised committees of the OECD. Much of the research and analysis is published, on paper or online.

For avoidance of double taxation, many countries (including members and non-members of the OECD) have entered into tax treaties that are based on the OECD Model and the Model Treaty of United Nations.

Broadly speaking, a tax treaty is to facilitate cross-border trade and investment by eliminating the tax impediments to these cross-border flows.

Its operational objectives are:

(1) elimination of double taxation and;
(2) prevention of fiscal evasion.

Specifically, a tax treaty has the following objectives as well:

(i) Elimination of discrimination against foreign nationals and non-residents.
(ii) Exchange of information between the Contracting States.
(iii) Provide dispute resolution mechanisms.

2.1 Role of the OECD Model Tax Treaty

It has no government or sovereign right and is a reference for double taxation issues. More importantly, it is a prototype document to harmonize regulations affecting international business. The OECD Model Tax Treaty (2010 version) contains seven chapters and 31 articles as follows:

- Ch. I, Articles 1-2: Scope of convention
- Ch. II, Articles 3-5: Definitions
- Ch. III, Articles 6-21: Taxation of income
- Ch. IV, Articles 22: Taxation of capital
- Ch. V, Article 23A-23B: Methods of Elimination of Double Taxation
- Ch. VI, Articles 24-29: Special Provisions
- Ch. VII, Articles 30-31: Final Provision

There are also a number of articles (such as tax and electronic commerce, harmful tax practices), which are of interest to the general public. For further details, please visit the website of the OECD at **http://www.oecd.org/**.

3 Double Taxation Arrangement (DTA) between the Mainland of China and the HKSAR

Topic highlights

DTAs provide certainty to investors on the taxing rights of the contracting parties and gives them more certainty as to the potential tax liabilities on their economic activities. They encourage trade by giving an added incentive for overseas companies to do business in Hong Kong, and likewise, for Hong Kong companies to do business overseas.

PRC Corporate Income Tax and Individual Income Tax is examinable but only in the context of the Hong Kong - Mainland China Double Taxation Arrangement.

3.1 DTA between the Mainland of China and the HKSAR

On 11 February 1998, the HKSAR Government and the Central People's Government entered into an Arrangement for the avoidance of double taxation between Mainland China and the HKSAR (please see DIPN 32). This Arrangement was in the form of a memorandum and it does not cover withholding taxes.

A new Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion with respect to Taxes on Income (the Mainland-HKSAR CDTA) was signed between the HKSAR and the Mainland on 21 August 2006.

The new Arrangement extends the scope of the original agreement on business profits and income from personal services. It covers direct income (such as operating profits and the employment income) as well as indirect income (such as dividends, interest and royalties). Ratification was completed on 28 December 2006. In the Mainland, the provisions of the Mainland-HKSAR CDTA shall apply to income derived in taxable years beginning on or after 1 January 2007; and in Hong Kong, in years of assessment beginning on or after 1 April 2007 (see DIPN 44 (Revised)).

On 30 January 2008, the Mainland and the HKSAR signed the Second Protocol to amend the Mainland-HKSAR CDTA. The Protocol came into effect as from 11 June 2008.

The Third Protocol was signed on 27 May 2010 which came into effect from 20 December 2010. The Third Protocol upgrades the Exchange of Information Article in the Arrangement to the 2004 version of OECD Tax Treaty Model. The Third Protocol requires the contracting parties, upon receiving a request for information, to exchange information even when there is no domestic tax interest involved.

3.1.1 Persons and taxes covered

The Arrangement applies to a person who is a resident of the Mainland or the HKSAR or both.

The term 'resident individual' in Hong Kong means (DIPN No. 44 (Revised), para 21):

- an individual who ordinarily resides in Hong Kong;
- an individual who stays in Hong Kong for more than 180 days during the relevant year of assessment or for more than 300 days in two consecutive years of assessment (one of which is the relevant year of assessment).

It is generally considered that an individual 'ordinarily resides' in Hong Kong if he has a permanent home in Hong Kong where he or his family lives. Other relevant factors include:

- the duration of his stay in Hong Kong;
- whether he has a permanent place of residence in Hong Kong;
- whether he owns any property overseas for residential purposes; and
- whether he is primarily resident in Hong Kong or overseas.

The term 'permanent home' refers to a home owned or possessed by an individual that is permanent in nature. In other words, this home must be retained for permanent use as opposed to being for temporary stays.

For a company, it will be considered to be a resident of Hong Kong if:

- it is incorporated in Hong Kong, or
- if it is incorporated outside Hong Kong and is normally managed or controlled in Hong Kong.

DIPN No. 44 (Revised) states that 'Management' refers to management of daily business operations or implementation of the decisions made by top management etc. while 'Control' refers to control of the whole business at the top level, including formulating the central policy of the business, making strategic policies of the company, setting work plans, implementing management's decision, choosing business financing, evaluating business performance etc. The board of directors usually exercises 'control'.

DIPN No. 44 (Revised) provides guidance on the Arrangement 2006 between the Mainland and the HKSAR. There are also a number of examples in DIPN No. 44 (Revised).

The Arrangement applies to the following taxes:

In the Mainland of China	In the HKSAR
Individual income tax	Profits tax
	Salaries tax
Foreign enterprises income tax*	Property tax
	Tax charged under personal assessment

* Corporate Income Tax (After the unification of the tax regulations applicable to foreign enterprises, foreign investment enterprises and domestic enterprises since 1 January 2008.)

3.1.2 Income from Immovable Properties

Pursuant to Article 6 of the Arrangement 2006, income derived by a resident of One Side from immovable property situated in the Other Side is taxable in the Other Side irrespective of whether the resident has a permanent establishment (as defined in Article 5, see below) on the Other Side.

3.1.3 Business profits

Pursuant to Article 7 of the Arrangement 2006, the business profits of an enterprise of One Side are taxable only in that Side unless the enterprise carries on business in the Other Side through a permanent establishment situated there.

Where an enterprise carries on business through a permanent establishment in the Other Side, the enterprise may be taxed in the Other Side but only to the extent that its income is attributable to the permanent establishment.

According to Article 5, 'permanent establishment'' includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources, a building site, a construction, assembly or installation or connected supervisory activities lasting more than six months, the furnishing of services, including consultancy services totalling more than six months within any 12-month period.

It does not include the use of facilities or the maintenance of a fixed place of business solely for the storage, display, or delivery of goods, the purchase of goods, advertising, collecting information or other information or other preparatory or ancillary activities.

However, if a person, other than an agent of independent status, habitually exercises an authority to conclude contracts on behalf of an enterprise in Other Side, the enterprise will be regarded as having a 'permanent establishment' in that Side.

Before the Second Protocol came into force on 11 June 2008, both Sides have different interpretation on the PE in relation to provision of consultancy services.

On 4 April 2007, the State Administration of Taxation ('SAT') released *Guoshuihan* [2007] No. 403 to provide interpretation and implementation guidelines on the New DTA.

Circular 403 stipulates that when determining 'six consecutive or cumulative months in any 12-month period', the entire period starting from the first month when the first employee arrives China until the last month when the last employee leaves China should be counted. In other words, even if the employees are present in China for one day in a particular month, that would still be regarded as 'a month'. However, it is subject to the exclusion of a period or periods of absence from China for this purpose, eg any period of 30 consecutive days without any services rendered by any employee working in China for the project can be excluded as 'a month'.

Conversely, the IRD considered the term 'month' to be a period of 30 days and therefore the relevant days of presence should be counted separately and then added together to ascertain if they in aggregate exceed 180 days (ie 30 days × 6) within any 12-month period.

According to the Second Protocol, which came into effect on 11 June 2008, 'six months' was changed to '183 days'.

In determining whether a Hong Kong enterprise providing services, including consulting services, in the Mainland is liable to the Corporate Income Tax, both sides have now agreed to substitute '183 days' for 'six months' as the basis of calculation.

In other words, Hong Kong enterprises would be considered as having a permanent establishment on the Mainland and be chargeable to Corporate Income Tax if they provide services in the Mainland for an aggregate of more than 183 days in any 12-month period commencing or ending in a taxable year.

The Third Protocol was signed on 27 May 2010 and became effective from 20 December 2010. The Third Protocol upgrades the Exchange of Information Article in the Arrangement to the 2004 version of the OECD Tax Treaty Model. The Third Protocol requires the contracting parties, upon receiving a request for information, to exchange information even when there is no domestic tax interest involved.

3.1.4 Shipping, aviation and land transport operations

Article 8 provides that income arising from the operation of ships, aircrafts or land transport vehicles by an enterprise of One Side shall be exempt from tax in the Other Side (except where the ships, aircrafts or land transport vehicles are solely operated between places of the Other Side). The taxes exempt in the Mainland of China include Enterprise Income Tax and Business Tax. The tax exempt in Hong Kong refers to Profits Tax.

3.1.5 Capital gains

Pursuant to Article 13,

(i) gains derived from the alienation of immovable property situated in the Other Side may be taxed in that Other Side.

(ii) gains derived from the alienation of movable property forming part of the business assets of the permanent establishment which an enterprise of One Side has in the Other Side, including such gains from the alienation of such permanent establishment may be taxed in that Other Side.

(iii) gains derived by an enterprise of One Side from the alienation of shares in a company whose assets are comprised, directly or indirectly, mainly (being not less than 50%) of immovable property situated in the Other Side may be taxed in that Side.

(iv) gains derived from the alienation of shares, other than those referred to in item (iii) above representing 25% or more of the entire shareholding of a company of the Other Side may be taxed in the Other Side.

In relation to item (iii), there will be an exemption from capital gains tax in the Mainland in the case of the sale of shares by a Hong Kong resident in a Mainland company whose assets are not directly or indirectly comprised mainly of immovable property situated in the Mainland. However, before the Second Protocol came into force on 11 June 2008, the Mainland and Hong Kong SAR held different views as to the definition of 50% mentioned in (iii) above. For (iii), the Mainland took the view that it meant any time in the past when the value of the immovable property equalled or exceeded 50% of the value of the total assets. Hong Kong was of the view that it meant the value of immovable property equalled or exceeded 50% of the value of the total assets of the company at the time of the alienation of shares.

In relation to item (iv), there will be an exemption from capital gains tax in the Mainland for a sale of shares in a Mainland company if the shares sold are less than 25% of the shareholding of the Mainland company. Before the Second Protocol came into force on 11 June 2008, both Sides interpreted the concept in relation to '25%' differently. Hong Kong interpreted the word 'shares' as referring to shares sold at the time of alienation, whereas the Mainland interpreted '25%' as referring to 25% or more of the shares in a company once held by the alienator.

According to the Second Protocol, the following changes were effective on 11 June 2008:

- Apart from some specified transactions in the arrangement and the Second Protocol, the gains derived by a Hong Kong resident from the alienation of immovable assets should be taxable in Hong Kong only.
- The gains derived by a Hong Kong resident from the alienation of shares in a Mainland company may be taxed in the Mainland, if the transferor has ever owned at least 50% of immovable properties within three years prior to the alienation transaction. The Second Protocol prescribed a limited look back period of three years before the date of the alienation of shares. In addition, book value shall be used as the basis for calculating the value of assets. (The SAT issued *Public Notice [2012] No. 59* on 31 December 2012 on the interpretation of the capital gain article in tax treaties signed by China. *Public Notice [2012] No. 59* stipulates that the value of total assets and immovable property should be determined in accordance with Chinese accounting standards. However, the value of the land or land-use rights included in the immovable property cannot be lower than the fair market value of comparable property at the same or a similar location. Under the prevailing Chinese accounting standards, the net book value is generally used to measured the value of land and buildings. Hence, *Public Notice [2012] No. 59* provides unfavourable treatment for taxpayers that have a land or a land-use rights with a net book value lower than the market price.)
- The gains derived by a Hong Kong resident from the alienation of shares, irrespective of the number of shares involved, in a Mainland company may be taxed on the Mainland, if within

12 months prior to the alienation transaction the transferor has ever owned not less than 25% of the entire shareholding of this Mainland company.

3.1.6 Employment income

Pursuant to Article 14, employment income derived by a resident of One Side is taxable in that Side unless the employment is exercised in the Other Side. Remuneration derived by resident of One Side in respect of employment exercised in the Other Side will be exempt from tax in the Other Side provided that:

(i) the taxpayer stays in the Other Side for a period or periods not exceeding the aggregate 183 days in any 12-month period commencing or ending in the taxable period concerned; *and*

(ii) the remuneration is paid by or on behalf of an employer who is not a resident of the Other Side*; and*

(iii) the remuneration is not borne by a permanent establishment which the employer has in Other Side.

3.1.7 Directors' fees, artistes and sportspersons

The relief provided in Articles 7 and 14 does not apply to directors' fees or income derived by artistes and sportspersons. Pursuant to Article 15, directors' fees and similar payments received by a resident of One Side in his or her capacity as a board of director of a company which is a resident of the Other Side may be taxed in that Other Side. Pursuant to Article 16, income derived by a resident artiste or sportsperson of one Side from personal activities exercised in the Other Side may be taxed in that Other Side.

3.1.8 Dividends, Interest and Royalties

Dividends

Article 10 provides that dividend paid by a company which is a resident of One Side to a resident of the Other Side, may be taxed in that Other Side, that is the Side of residence has the right to tax the dividends. The Side of source may also tax dividends according to the laws of that Side.

However, the tax so charged shall not exceed 10% of the gross amount of the dividends, and 5% of the gross amount of the dividends if the beneficial owner is a company directly holding at least 25% of the capital of the company paying the dividends.

As dividends are exempt from tax in Hong Kong, the limitation of tax rates currently has no practical tax impact in Hong Kong.

Interest

Article 11 provides that the source of interest is the Side in which the interest arises. The limitation of tax rates in the Side in which the interest arises is a maximum of 7% of the gross amount of the interest. Interest received by the Government of the Other Side or any recognised institutions is exempt from tax in the Side of source.

Royalties

For royalties, the provision of Article 12 and the criteria for determining the locality of the source of royalties are the same as those for interest under Article 11. The tax rate is limited to 7% of the gross amount of the royalties.

However, as the applicable tax rate at 7% is higher than the effective tax rate of 4.95% for corporations and 4.5% for non-corporations in normal situation by virtue of ss.15(1)(a), (b), or (ba) and 21A where applicable, the royalties paid to a Chinese resident will be taxed at the rate of 4.95% instead of the rate limit as provided in the Arrangement 2006.

For s.15(1)(d) sums which are chargeable to Hong Kong Profits Tax on an actual basis, it is necessary to compute the tax payable before one can decide whether 7% is more advantageous.

In DIPN 44 (Revised), the IRD took the view that according to Article 25 of the Arrangement 2006 if royalties arising in Hong Kong and paid to a resident of the Mainland are part of a scheme directed

at exploiting s.21A of the IRO, the Arrangement 2006 will not prejudice the right of Hong Kong to apply its laws and measures concerning tax avoidance. *Inter alia*, the relevant anti-avoidance provisions include s.21A(1)(a). According to s.21A(1)(a), if the payer and recipient of the royalties are associated companies and the intellectual property has been owned wholly or partly by any person carrying on business in Hong Kong previously, the assessable profit in respect of the royalties would be 100% of the royalties (rather than 30%, which brings the effective tax rates down to 4.95% and 4.5% as mentioned above).

3.1.9 Methods of elimination of double taxation

Article 21 provides that taxes paid on One Side shall be allowed as a credit against taxes payable on the Other Side in respect of the same item of income. However, the amount of tax credit shall not exceed the amount of tax computed in respect of that income in accordance with the taxation laws and regulations of the resident's home jurisdiction.

3.1.10 Transfer pricing adjustments

Article 9 provides that taxation authorities of Both Sides may make transfer pricing adjustments in cases where the transactions between associated enterprises have not been entered into on an arm's length basis.

3.1.11 Exchange of information

Article 24 allows taxation authorities of Both Sides to exchange such information as is necessary for carrying out the provisions of the Arrangement 2006 or of the domestic laws of Both Sides concerning taxes covered by the Arrangement 2006.

The Third Protocol signed on 27 May 2010 (came into effective from 20 December 2010) upgrades the Exchange of Information (EoI) Article, Article 24, to the 2004 version of the Organisation for Economic Cooperation and Development's Model Tax Agreement.

The EoI Article requires the contracting parties, upon receiving a request for information, to exchange tax information foreseeably required for applying the Arrangement or the domestic law, even where the requested party does not need such information for its own tax purposes. The previous version of the EoI clause only allowed tax information to be exchanged where it related to the administration of taxes under the domestic law of the jurisdiction in which it was requested.

Limitations.

Both parties are obliged to keep the information received confidential and can only disclose the information to persons involved in the assessment and determination of tax, including courts and state departments of administration.

Also, in the course of obtaining the requested information, a party should not carry out measures at variance with local law, or supply trade or industrial information to the requesting party in a manner contrary to public policy. However, a request for information cannot be refused on the grounds that the information is held by banks, other financial institutions, parties acting in a trustee capacity, or because it relates to ownership interests in a person.

The Third Protocol came into effect on 20 December 2010.

The IRD has issued DIPN No. 47 in respect of their application of exchange of information under the double taxation agreements and arrangement. Please refer to section 4.3 for details.

3.1.12 Mutual agreement procedure

Article 23 provides that any difficulties or doubts arising as to the interpretation or application of the double tax arrangement are to be resolved by the competent authorities of the Mainland and the HKSAR.

3.1.13 Relationship between the Mainland-HKSAR CDTA and the IRO

The CDTA has been implemented in accordance with s.49 of the IRO and accordingly has legal effect. The CDTA and the IRO (including subsidiary legislation) are interrelated and complement each other. The CDTA performs the function of allocating the right to tax between the two Sides.

When the right to tax has been allocated, both Sides will continue to refer to their respective domestic taxation legislation to resolve problems of tax administration and enforcement, such as in deciding whether certain income should be subject to tax, and in the computation of assessable income and tax payable.

In handling problems arising from any inconsistency between the CDTA and the IRO, priority will be accorded to the CDTA to ensure compliance with its provisions. Hong Kong adopts the 'preferential treatment' principle, ie where the CDTA and the IRO contain different provisions relating to the same matter, preference will be given to the provisions that are most beneficial to the taxpayers. For example, if a Mainland resident renders employment services in Hong Kong but does not meet the exemption conditions stipulated in Article 14 (eg his remuneration is paid by a Hong Kong employer), he will still be exempt from tax under the IRO if his visit to Hong Kong in the year of assessment concerned does not exceed a total of 60 days.

The CDTA should not affect existing concessional practices in Hong Kong. For instance, a Hong Kong manufacturer concludes a contract processing arrangement with a Mainland entity. In accordance with paragraphs 33 to 34 of Departmental Interpretation and Practice Notes No. 21 (Revised 2009), 50% of his profits may be regarded as profits arising outside Hong Kong and not chargeable to profits tax in Hong Kong.

This method of apportioning profits that arise both inside and outside Hong Kong on a 50:50 basis remains applicable. According to the provisions of the CDTA, the Hong Kong manufacturer could be regarded as having a permanent establishment in the Mainland and is therefore liable to tax there. However, it is noted that it is not the present intention of the Mainland to change the way it taxes profits derived from this type of operation. Nevertheless, the possibility that in future, profits attributable to the permanent establishment may be taxed in accordance with the CDTA cannot be ruled out.

3.1.14 Tax planning opportunities under the Arrangement and IRO

There are tax-planning opportunities under the Mainland-HKSAR CDTA. Some ideas are discussed as follows:

Business profits

Article 7 of the Arrangement provides that the business profits of an enterprise of One Side are taxable only in that Side unless the enterprise carries on business in the Other Side through a permanent establishment situated there. A Hong Kong company could structure its business operation in the Mainland to ensure the operation would not constitute a permanent establishment in China.

For example, a Hong Kong company intends to make sales to customers in the Mainland via the Internet.

To facilitate efficient goods delivery, the company would rent a warehouse in the Mainland. If the warehouse is simply for storage of goods of the Hong Kong company, the Hong Kong company would not be regarded as maintaining a permanent establishment in the Mainland. Accordingly, it would not be subject to Corporate Income Tax in the Mainland. The same strategy can be adopted by a Chinese company having a similar operation in Hong Kong if it would like to minimise its exposure to Hong Kong Profits Tax.

If a Hong Kong company needs to appoint any agent in the Mainland, it should ensure that the agent does not have any general authority to conclude contracts with either suppliers or customers on its behalf. For instance, the agent needs to seek instruction and approval from the Hong Kong principal from time to time in the course of negotiation of a contract on behalf of the Hong Kong principal. Similarly, a Chinese company should ensure its Hong Kong agent, if any, does not have any authority to conclude contracts on its behalf in Hong Kong in order to minimise its Hong Kong Profits Tax exposures.

For provision of consultancy services in the Mainland, a Hong Kong company should limit the number of days of services to not more than 183 days within any 12-month period so that the Hong Kong company would not constitute a permanent establishment in the Mainland. For instance, it may consider segregating a contract by the nature of its various services so that the service time of

each contract would not be more than 183 days (assuming that the tax authorities agree that the services rendered under each contract are not correlated. Correlated contracts are counted as the one contract). This strategy can also be used for a Chinese company rendering consultancy services in Hong Kong.

Foreign transportation companies might also take benefits from setting up Hong Kong subsidiaries to conduct land transport business with the Mainland as there is an exemption from PRC Business Tax and Corporate Income Tax for land transport income.

Staff remuneration

A Hong Kong company that provides services in the Mainland could avoid paying PRC Corporate Income Tax if it would be able to restrict the time spent by its staff rendering services in the PRC to no more than six months (183 days according to the Second Protocol) in any 12-month period. Hence, such Hong Kong company would not constitute a permanent establishment in the Mainland.

An employee of a Hong Kong company would not be subject to PRC Individual Income Tax provided that he or she does not spend more than 183 days within any 12-month period in China **and** his/her remuneration is not borne by or charged to any PRC establishment.

Hong Kong Holding Company – Withholding tax

A Hong Kong company is a preferred choice of special purpose vehicle for foreign investors who would like to make investments into China.

The normal withholding rate (Corporate Income Tax) for dividend, interest and royalty received by foreign enterprises in the Mainland is 10%. However, the withholding tax rate on dividends is reduced from 10% to 5% if the dividends are paid by a Chinese company to its Hong Kong holding company which holds at least 25% of the capital of the Chinese company. 10% rate applies to all other cases.

Under the Mainland – HKSAR CDTA, the withholding tax rate on interest and royalties is reduced from 10% to 7%.

The PRC SAT issued an anti-tax avoidance notice, *Guoshuihan [2009] 601*, in 2009 setting out guidelines on the interpretation and determination of the term 'Beneficial Owner', which is a pre-requisite to enjoying the benefit of a reduced tax rate on passive income such as dividends, interest and royalties under the double tax treaties.

Under Circular 601, an individual, a company or any other organisation can be a beneficial owner if the following requirements are met:

- The person owns or controls the income, or the assets or rights from which the income is generated;
- The person is engaged in substantive operational activities, such as manufacturing, distribution, or management; and
- The person is neither an agent nor a conduit company.

The requirement of substantive operational activities could be a challenge for some offshore holding companies, which have virtually no or very few business activities, other than merely holding and administering lower-tier subsidiaries. These offshore holding companies in current form are unlikely to qualify as beneficial owners under *Guoshuihan [2009] 601*.

Guoshuihan [2009] 601 expressly lists the following seven factors, which generally lead to unfavorable results, in determining beneficial owners:

- The applicant is obligated to pay or distribute all or substantially all the income (e.g. more than 60 percent) to a resident of a third jurisdiction within a prescribed time limit (e.g. 12 months following the receipt of the income);
- The applicant has no or few business activities, other than holding the assets or rights from which the income is generated;

- Where the applicant is a company or other entity, its size in terms of assets, scale and number of employees is disproportionately small relative to the amount of income;
- The applicant has no or few rights to control or dispose of the assets or rights from which the income is generated and bears no or few risks;
- The treaty partner does not tax the income, exempts the income from tax, or imposes tax on the income at a very low effective rate;
- For a loan contract from which the interest is generated and paid, the creditor and a third party enter into a back-to-back loan or deposit contract with similar principal amount, interest rate and signing date;
- For a copyright, patent or technology licensing contract from which the royalty is generated and paid, the applicant and a third party enter into a back-to-back copyright, patent, or technology licensing or transfer contract.

On 29 June 2012, the SAT promulgated Public Announcement No. 30 to provide further guidance on the interpretation and determination of beneficial owners under *Guoshuihan [2009] 601*.

The salient points of Public Announcement No. 30 are as follows:

- The existence of one negative factor cannot lead to the conclusion that the applicant is not the beneficial owner of the received income.
- The absence of the intention of tax avoidance/reduction does not mean the applicant is the beneficial owner.
- In interpreting factors in *Guoshuihan [2009] 601*, reference can be made to articles of association, financial statements, cash flow records, board meeting records, board resolutions, asset and personnel status, relevant expenditures, function and risk assumptions, loan agreements, royalty or licence agreements, patent registration certificates, copyright ownership certificates and agency agreements or designated recipient contracts etc.
- There is a safe-harbour rule – if an applicant in a treaty state receives dividend income out of China, and it is listed on the stock exchange of that state or 100% owned directly or indirectly by another company resident and listed in the same state, and the dividend income is derived from the shares held by that listed company, the applicant can be regarded as the beneficial owner of the dividends received. An indirect ownership through a company in a third jurisdiction does not qualify.
- If an agent receives income on behalf of the applicant, the beneficial ownership of the applicant shall not be affected by the existence of such an agent, no matter whether the agent is a resident of the contracting state or not.
- Only the provincial-level tax bureau would have the authority to deny beneficial ownership status.

Hong Kong Holding Company – Capital Gain

A company, which is incorporated in a country having no tax treaty with China, can use a Hong Kong company as an investment vehicle to hold investment in shares of Chinese companies, instead of directly holding the Chinese companies. Indirect disposal of the underlying equity interests in the Chinese companies by transferring the sales of the Hong Kong company to the buyer may be exempt from Corporate Income Tax in the Mainland if the required conditions are satisfied. However, if there is no substance in the Hong Kong holding vehicle, the PRC tax authority can disregard the Hong Kong company for the indirect transfer.

Please refer to discussion on Article 13 above for details of the exemption criteria. The disposal of investments in the Chinese companies can be effected by way of disposal of the Hong Kong investment vehicle. There is no Capital Gains Tax in Hong Kong. If the disposal of the Hong Kong

company does not constitute as a trading transaction, the related disposal gain would not be subject to Profits Tax in Hong Kong.

Anti-avoidance rules

You should bear in mind that all the above tax planning ideas are subject to practical considerations and the challenge of general anti-avoidance rules in the Mainland and Hong Kong. Please refer to chapter 9, section 4 for detailed discussion of anti-avoidance rules in Hong Kong.

The PRC SAT issued an anti-tax avoidance notice, *Guoshuihan [2009] 698*, in respect of the indirect transfer of equity interests by non-resident enterprises. Circular 698 took effect retroactively from January 1, 2008.

Pursuant to *Guoshuihan [2009] 698*, the tax authorities can recharacterise an indirect equity transfer by *disregarding* the existence of an offshore holding company, if an upper-tier foreign investor is deemed to abuse the holding company structure and seek to avoid Chinese Corporate Income Tax through an indirect transfer of equity interests in a Chinese resident enterprise without reasonable business purpose.

4 Double taxation reliefs

Topic highlights

Under a DTA, a Hong Kong resident who is liable to tax in respect of the same income in both Hong Kong and the contracting territory will be provided with a relief by way of tax credit.

The allowable tax credit is to be computed in accordance with s.50(3) and s.50(5) of the IRO. The amount of tax paid in the Mainland not allowed as a tax credit could be allowed as a deduction.

Example: Double taxation relief

Company A, a Hong Kong resident, derived service fee income from Hong Kong and the Mainland. The IRD assessed all the profits of Company A to tax in Hong Kong.

	Hong Kong	*Mainland*	*Total*
	$	$	$
Service fee income	8,000,000	2,000,000	10,000,000
Less: Operating expenses	6,400,000	1,600,000	8,000,000
Assessable profits	1,600,000	400,000	2,000,000

Profits tax payable – before double taxation relief ($2,000,000 × 16.5%)	330,000
PRC income tax paid ($400,000 × 25%)	100,000
Total	430,000

Required

Compute the Hong Kong profits tax payable by Company A for the year of assessment 2009/10 under the double taxation arrangement between the HKSAR and the Mainland of China.

Solution

	$	$
PRC tax paid ($400,000 × 25%)		100,000
Credit limit of tax paid in the Mainland:		
Net income from the mainland grossed up at (400,000 – 100,000) × 1/(1 – 16.5%)	359,281	
Less: net income from the Mainland after deduction of tax (400,000 – 100,000)	(300,000)	
Tax credit limit for tax paid in the Mainland		(59,281)

	$	$
Amount not allowed as a tax credit		40,719
Hong Kong profits tax payable:		
Assessable profits		2,000,000
Less: amount not allowed as a tax credit		40,719
		1,959,281
Tax rate		16.5%
Tax thereon		323,281
Tax credit		(59,281)
Hong Kong profits tax payable after allowance of tax credit		264,000
Total tax paid by Company A:		
Hong Kong profits tax		264,000
PRC income tax		100,000
Total		364,000

4.1 Relief from double taxation due to transfer pricing adjustment

DIPN No. 45, issued in April 2009, sets out the IRD's views and practices on granting relief from double taxation due to transfer pricing adjustment or profit allocation adjustment under a double taxation agreement/arrangement (DTA).

DIPN No. 45 categorises double taxation into two types: economic double taxation and juridical double taxation.

Economic double taxation means two enterprises residing in different states are assessed to tax on the same profit or income.

For instance, the profits of an enterprise are adjusted upwards as a result of a primary transfer pricing adjustment made by the tax authority of the home state which increases the tax charged on the enterprise in a transaction. However, the tax authority of other state does not make a corresponding downward adjustment to the tax charged on the associated enterprise involved in the transaction.

Juridical double taxation means an enterprise is charged to tax on the same profit or income in two different states, without either state providing relief for tax imposed by the other.

For instance, a single entity having a head office in its state of residence has set up a permanent establishment in another state. The profit attributable to the permanent establishment is subject to tax in both states.

DIPN No. 45 states that where a transfer pricing or profit re-allocation adjustment is made in a non-DTA context, there are no procedures in place to provide any relief from the resultant double taxation.

In Hong Kong, generally, relief for double taxation can only be obtained under a double taxation agreement/arrangement, if one exists between Hong Kong and the state concerned, as the Inland Revenue Ordinance does not contain any provision granting unilateral tax credit relief, but only tax deduction for tax paid overseas in certain limited circumstance.

4.1.1 Economic double taxation

Generally under a DTA, when the tax authority of one state makes a primary transfer pricing adjustment to the tax position of an enterprise in that state for goods or services etc it provides to an associated enterprise in the other state, the tax authority of the other state is obliged to make a corresponding adjustment to the tax position of the associated enterprise so as to avoid double taxation of the same profit. In Hong Kong, the claim for such corresponding adjustment must be

made by the taxpayer within six years after the end of the relevant year of assessment under s.79 of the IRO, which allows tax paid in excess to be refunded under certain conditions.

DIPN No. 45 specifically states that the relief for economic double taxation can only be sought by way of a corresponding adjustment, but not for a retrospective price adjustment.

DIPN No. 45 also states that such a retrospective price adjustment would not represent outgoings or expenses incurred in the production of chargeable profits and hence deductible under s.16. Moreover, DIPN No. 45 makes it clear that the relevant assessment cannot be re-opened under s.70A as the retrospective price adjustment constitutes neither an error nor omission made in the taxpayer's return or statement filed with the IRD for the year concerned.

4.1.2 Juridical double taxation

The 'Business Profits Article' in all the DTAs that Hong Kong has signed allows the tax authority of a source state to tax an enterprise, which is a resident of the other state, carries on business in the source state through a permanent establishment (PE).

The profits that can be taxed in the source state are those attributable to the PE only.

In determining the profits attributable to the PE, both the resident and source states are bound by the principle stated in the 'Business Profits Article' that transactions between the PE and other parts of the enterprise such as its head office have to be made on an arm's length basis.

Juridical double taxation would be avoided by way of the resident state either:

- exempting on its side the profits attributable to the PE in the source state; or
- granting a tax credit of the tax paid in the source state against the tax payable on its side on the same profits.

In case the profits as reflected in the accounts of the PE do not represent arm's length profits, the tax authority of the source state may make a profit reallocation adjustment under the 'Business Profits Article' of the relevant DTA. In such a situation, the tax authority of the resident state, if it agrees with the adjustment made, would be obliged to revise the previous exempt profit or tax credit calculation of the enterprise on its side so as to avoid double taxation.

For the claim to revise the non-taxable offshore profits attributable to the overseas PE of a Hong Kong resident (i.e. to increase the offshore profit), the relevant adjustment is made under the 'Business Profits Article' and s.79 of the IRO. The time limit for invocation of s.79 is six years after the end of the relevant year of assessment.

For the claim on an additional tax credit, the relief is granted under the 'Methods for Elimination of Double Taxation Article' of the DTA and s.50 of the IRO. The time limit for the claim in Hong Kong under s.50 is within two years from the time the other state made the adjustment.

4.1.3 Mutual Agreement Procedure Article

The Commissioner would only be obliged to make corresponding adjustments in Hong Kong up to the extent to which she agrees that the tax adjustments made by the other state represent the arm's length principle. If the Commissioner does not fully agree with the adjustment of the other state, it is expected that the two authorities would communicate with each other so as to resolve the issue.

In any case, if a taxpayer in either state of a DTA considers that the actions of the tax authority of their state or the other state or both result in them not being taxed in accordance with the provisions of the DTA, they can formally invoke the 'Mutual Agreement Procedure Article' of the DTA to seek remedy.

Under the 'Mutual Agreement Procedure Article' of all the DTAs that Hong Kong has signed, a taxpayer has to initiate the procedure with the competent authority of their resident state within three years from the time of the first notification to them of the actions giving rise to taxation not in accordance with the DTA.

The competent authority of the taxpayer's resident side will then consider and resolve the case on its own if possible or where necessary, endeavour to resolve the issue with the competent authority

of the other side (however, without the obligation of necessarily reaching agreement with the competent authority of the other side).

This mutual agreement procedure is generally available in addition to the objection rights or other avenues for redress that a taxpayer may have under the domestic law of the state to which they are subject to. Furthermore, any agreement reached under the procedure shall be implemented notwithstanding any time limits in the domestic laws of both sides.

4.2 Transfer pricing guidelines – methodologies and related issues

The IRD issued DIPN 46 on 4 December 2009. DIPN 46 provides the basis on which the IRD will assess the arm's length nature of taxpayers' related party transactions, make transfer pricing/profit reallocation adjustments and determine whether a transfer pricing adjustment initiated by a party other than the IRD is correct. DIPN 46 relies on ss.16, 17(1), 20, 61 and 61A as the basis for the Commissioner's powers on making transfer pricing adjustments.

4.2.1 Arm's length principle and associated enterprises

According to DIPN 46, the arm's length principle utilises independent transactions as the benchmark to determine how profits and expenses should be allocated for transactions between associated enterprises.

Further, DIPN 46 (paragraphs 5) notes, that 'the basic rule for Double Taxation Agreement purposes is that profits tax charged or payable should be adjusted, where necessary, to reflect the position, which would have existed if the arm's length principle had been applied instead of the actual price transacted between the enterprises'.

The arm's length principle is also embodied in the Associated Enterprise and the Business Profits Articles of the OECD Model Tax Convention on Income and Capital (MTC), which has been adopted in the comprehensive double taxation agreements (CDTAs) concluded by Hong Kong.

Therefore, when a CDTA is in force, the IRD will also rely on such CDTA to combat non-arm's length transactions.

In defining 'Associated Enterprise', DIPN 46 makes reference to the Associated Enterprises Article of the MTC, as follows:

'Where

(a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise or a Contracting State and an enterprise of the other Contracting State,…'

Though the IRD makes reference to MTC in defining 'Associated Enterprise', the IRD regards the existence of a CDTA is not a pre-requisite for making transfer pricing adjustments.

Where the circumstances warrant, transfer pricing adjustments will be made to transactions under the provision of the IRO. Therefore, related party transactions between a Hong Kong entity and a non-treaty country entity are equally as relevant as related party transactions between a Hong Kong entity and a treaty country entity. Both are subject to transfer pricing investigation if the IRD deems it necessary. The only difference is that when transfer pricing adjustments are made to non treaty entities, no Mutual Agreement Procedure (MAP) for relief from double taxation will be available.

4.2.2 Transfer pricing methodologies

The practice on transfer pricing adjustments to be followed by the IRD will not differ from transfer pricing methodologies recommended by OECD Transfer Pricing Guidelines, i.e. (i) traditional transaction methods: the comparable uncontrolled price method, the cost plus method, and the resale price method; (ii) the transactional profit methods: the profit split method and the transactional net margin method.

Consistent to current OECD Transfer Pricing Guidelines, there will be a preference for traditional transaction methods over transactional profit methods. However, it is noted that under the draft discussion paper circulated by the OECD regarding 'Proposed Revisions of Chapters I-III of the Transfer Pricing Guidelines (9 September – 9 January 2010)', paragraphs 2.1-2.9, that it is proposed to replace the hierarchy of methods with the 'most appropriate method to the circumstances of the case'.

4.2.3 Attribution of profits and expense to a permanent establishment

Attribution of profits and expense to a permanent establishment is broadly consistent with the OECD Report of the Attribution of Profits to Permanent Establishment (2008) in regard to the adoption of the 'functionally separate entity' approach as the 'authorised OECD approach'. When attributing profits to the permanent establishment in Hong Kong, the Commissioner would consider the significant people functions and the key entrepreneurial risk-taking functions. (ie those functions which are relevant to the assumption or acceptance of management risks).

4.2.4 Intra-group services

DIPN 46 includes an extensive discussion on the relevant transfer pricing principles to be applied in cases involving intra-group service arrangements. It emphasizes the importance of the benefit test and in terms of the quantum of the service charge, refers to the OECD concepts of direct versus indirect charging. As to the issue on mark-up, the IRD indicates that a mark-up is likely to be required whenever the service activity constitutes a materials component of the service provider's business or where the potential profit component is significant.

4.2.5 Documentation

Though transfer pricing documentation is not mandatory, DIPN 46 contains guidelines in relation to transfer pricing documentation and provides an explicit recommendation for taxpayers to prepare such documentation. The IRD notes the record keeping requirements of s.51C and points out that enterprises carrying on business in Hong Kong may be called upon by the IRD to justify their prices and the amount of profits or losses returned for tax purposes in the event of enquiry, audit or investigation. Particularly, in Example 5 of paragraph 60 of DIPN 46, it is stated the CIR would not recognise a claim for deductions related to market penetration expenses without first seeing taxpayer's contemporaneous documentation.

4.2.6 Corresponding adjustment

CDTA corresponding adjustment is not automatic. The IRD has to satisfy that adjustments will be consistent with arm's length price for there to be double tax relief. Again, while documentation is not mandatory, the DIPN 46 suggests that upon investigation or MAP requests, robust OECD-type documentation is still expected by the IRD.

4.2.7 Application of anti-avoidance provisions to 'tax schemes'

DIPN 46 mentions that ss.16 and 17 can be used to make transfer pricing adjustments, even without invoking anti-avoidance provisions, i.e. ss.20, 61 and 61A. DIPN 46 also mentions that ss.20, 61, 61A will be aggressively applied where structures or transactions are created with tax evasion/avoidance as the primary motivation. DIPN 46 provides examples of such structures, including establishment of tax haven re-invoicing companies which perform no economically significant functions.

4.3 Exchange of information

DIPN 47 sets out the practice of the IRD on the processing and exchange of tax information ('**EoI**') upon requests received from treaty partners, following the enactment of the Inland Revenue (Amendment) Ordinance 2010 and the Inland Revenue (Disclosure of Information) Rules, Cap.112BI ('Disclosure Rules'). It explains the safeguards available to taxpayers and the procedural guidelines to be followed by officers of the IRD.

The OECD Model EoI Article provides for broad information exchange but it does not limit nor commit the contracting parties as to the forms or manner in which information exchange can take place. The provisions of the OECD Model allow information to be exchanged in three different

ways: (i) upon request; (ii) automatically; or (iii) spontaneously or any combination of the above three modes. The manner in which the exchange of information is to be effected will be decided upon during the treaty negotiation between the two sides.

Hong Kong's policy on the exchange of information is restricted to exchange upon request, and Hong Kong will not provide any information in automatic or spontaneous exchanges. Hong Kong will only supply information, including bank information, upon specific and *bona fide* requests received from the competent authority of a treaty partner in justifiable cases.

The standard of the OECD Model in referring to information that may be relevant is intended to facilitate the exchange of tax information but at the same time the contracting parties are not allowed to engage in 'fishing expeditions', i.e. speculative requests for information that have no apparent nexus to an open enquiry or investigation or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer.

The information that a requesting party should provide to demonstrate that the requested information is 'foreseeably relevant'.

Hong Kong only authorises the exchange of information and the use of information exchanged in relation to the administration and enforcement of taxes covered by the respective DTAs.

The information exchanged shall not be used for purposes other than those for which it has been exchanged. The information pursuant to the DTA cannot be used for non-tax purposes.

The IRD is also not obliged to disclose information where:

- the requesting party itself would be unable to obtain the information in the normal course of its administration;
- the requested party has no mechanism in place to obtain the information;
- where provision of the information would be contrary to public policy;
- where the information constitutes trade or business secrets; and
- where the information is protected by legal professional privilege.

The Inland Revenue (Amendment) Bill 2013 was introduced on 12 April 2013. The Bill aims to enable Hong Kong to enter into Tax Information Exchange Agreements (TIEAs) with other jurisdictions where necessary and to enhance the existing exchange of information arrangements under comprehensive avoidance of double taxation agreements.

At present, under the IRO, Hong Kong can only exchange tax information with another jurisdiction under the framework of a DTA that Hong Kong has entered into with that other jurisdiction.

Under the proposed amendments, Hong Kong can enter into a TIEA with other jurisdictions simply for the purpose of exchange tax information in relation to any tax imposed by the laws of Hong Kong or that jurisdiction. In addition, persons who do not possess but have control of the information will also be obligated to supply the information upon request. The Bill was subsequently passed on 10 July 2013.

4.4 Advance Pricing Arrangement

DIPN 48, issued in March 2012, provides guidance for enterprises seeking an Advance Pricing Arrangement (APA) with the IRD. DIPN 48 explains the APA process and the terms and conditions of the APA process prescribed by the IRD.

In the comprehensive DTAs concluded by Hong Kong, the Associated Enterprises Article has incorporated provisions which mandate the adoption of the arm's length principle for pricing controlled transactions. The IRD will ensure that enterprises operating in Hong Kong declare a level of profit from controlled transactions that is commensurate with the functions carried out, the assets used, and the risks assumed in Hong Kong.

The APA process gives enterprises the opportunity to reach agreement with the IRD on the method of applying the arm's length principle to controlled transactions so that transfer pricing issues can be

more efficiently dealt with in real time as they arise, rather than retrospectively years later. It prevents costly and time consuming audit and litigation of transfer pricing issues covered by the APA. Upon the expiration of the term of an APA, the enterprise may have the opportunity to renew the APA, thus prolonging the advantages.

An APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing of those transactions over a fixed period of time. Controlled transactions refer to transactions between enterprises that are associated enterprises with respect to each other under the Associated Enterprises Article of the relevant DTA. The IRD would extend the scope of an APA to cover transactions between a permanent establishment and its head office or between two permanent establishments of the same enterprise.

The APA will not agree precisely the actual profit which should be taxed in Hong Kong in the future. The APA should fix arrangements according to the arm's length principle for determining the transfer pricing for the future transactions in the APA. In general, an APA will apply for three to five years.

A unilateral APA is an arrangement between the IRD and the enterprise concerning the transfer pricing of controlled transactions. The APA process does not involve the agreement with a DTA partner. As such, it does not guarantee the agreement of the DTA partner to the arrangement made.

A bilateral APA is an arrangement between the IRD and a DTA partner concerning the transfer pricing of controlled transactions. It is concluded under the Mutual Agreement Procedure (MAP) Article of the relevant DTA. Upon mutual agreement having been made, each side confirms the terms of the APA in writing through a letter or similar document with their respective resident enterprises and agrees to be bound by them. A bilateral APA therefore provides certainty to enterprises that double taxation will not arise.

A multilateral APA is an arrangement between the IRD and two or more DTA partners concerning the transfer pricing of controlled transactions. It is likewise concluded under the MAP Articles of the relevant DTAs. Upon mutual agreement having been made, each side confirms the terms of the APA in writing through a letter or similar document with their respective resident enterprises. A multilateral APA binds all parties and provides certainty to enterprises that double taxation will not arise.

If the enterprise has agreed to and complied with the terms of an APA, the IRD will be administratively bound by the terms of the APA. The APA requires the enterprise to comply with particular requirements and depends on critical assumptions being met. If the requirements are complied with and the assumptions are met, the IRD will not impose additional profits tax on the covered controlled transactions other than the tax payable on the pricing worked out under the APA.

The APA process is most suitable for complex controlled transactions with high transfer pricing risk (e.g. few comparables can be found; a significant amount of tax is involved; significant profits are shifted out of Hong Kong). During the APA process, the IRD may make an attempt to resolve the related collateral issues, if any.

The tentative timeframe for concluding an APA is 18 months from the acceptance of the formal application. The timeframe however will depend on the progress of negotiation with the Competent Authority(ies) of the DTA partner(s), which could take an extra six months depending on the scheduling of the Competent Authorities meetings concerned. Generally, a longer timeframe is required in more complex cases.

The APA process has five distinct stages:

Stage 1:	Pre-filing
Stage 2:	Formal application
Stage 3:	Analysis and evaluation
Stage 4:	Negotiation and agreement
Stage 5:	Drafting, execution and monitoring

The IRD will require the enterprise, as part of the APA process, to prepare and submit an Annual Compliance Report (ACR), for each year of the APA, containing sufficient information to detail the actual results for the year and to demonstrate compliance with the terms of the APA. The ACR is distinct from the enterprise's obligation to submit a tax return under section 51(1) of the IRO.

If an enterprise fails to comply with the annual reporting requirements, the Commissioner will not be bound by the APA. The IRD will consider revoking retrospectively the APA such that it was deemed not to have existed or cancelling the APA such that it will not apply for any period remaining of the term of the APA.

The enterprise must retain all records relied upon in concluding the APA and all supporting data referred to in any Annual Compliance Report or used in applying the APA for a period of seven years after the end of the APA period. The APA may specify the record retention period or specifically provide that certain records need to be retained.

A unilateral/bilateral/multilateral APA may be renewed with the consent of all the parties to it, including the DTA partner(s). The enterprise should seek renewal at least six months before the expiration of the existing APA. This allows the renewal to be negotiated and put in place prior to the expiration of the earlier APA period so that the renewal can be concluded prospectively.

The IRD may either revoke the APA such that it was deemed not to have existed, cancel the APA such that it will not apply for any period remaining of the term of the APA or revise the APA, where an enterprise makes a statement that is false or misleading, or omits from a statement any matter or thing without which the statement is false or misleading, in either the APA application or any other submission, report, information or documentation regarding or supporting the APA application. Tax shelters, offshore structures (tax efficient or not) and tax schemes directly or indirectly related to the controlled transactions must be disclosed and must not be omitted from disclosure.

Self-test question 1

Ms. Wong is the managing partner of a Hong Kong-based accounting services firm (the Firm). The Firm has offices in Central District and a representative office in Shanghai through which it services its clients based in the Mainland.

In March 2010, Ms. Wong was approached by a Hong Kong subsidiary of a State-owned enterprise in Shanghai to carry out work relating to listing the shares of that subsidiary on the Hong Kong Stock Exchange. She then accepted the offer on behalf of the Firm and signed the Firm's normal retainer agreement in Shanghai on 28 April 2010. The service fee is a fixed sum of $3,000,000 plus an extra amount of $500,000 if the listing was satisfactorily completed on or before 30 November 2010.

Due to the difficulties of recruiting staff familiar with Mainland labour laws, product liability and property ownership, Ms. Wong arranged for a local Shanghai law firm to assist in performing the work that must be carried out in the Mainland. Periodically, Ms. Wong will also visit Shanghai and work with the resident officer of the Firm's representative office in Shanghai to supervise the lawyers of the local Shanghai law firm. A great deal of due diligence has to be undertaken by the Firm for the purpose of listing the shares of the subsidiary on the Hong Kong Stock Exchange. Although part of this work can be carried out in Hong Kong, the majority will need to be done on site in the Mainland.

Required

Explain to Ms. Wong whether the service fee in question is subject to profits tax. You should, if relevant, discuss the application of the Mainland/Hong Kong Arrangement for the Avoidance of Double Taxation.

(The answer is at the end of the chapter)

5 Other Double Taxation Agreements

Topic highlights

Besides the double taxation arrangement entered between the Mainland and Hong Kong, Hong Kong has also signed comprehensive DTAs with other jurisdictions.

In order to enhance Hong Kong as an investment platform and a gateway for inbound and outbound investments, Hong Kong has accelerated its treaty negotiations with other jurisdictions. As of 1 June 2013, Hong Kong has concluded comprehensive double taxation agreements with 29 jurisdictions including Belgium, Thailand, the Mainland of China, Luxembourg, Vietnam, Brunei, the Netherlands, Indonesia, Hungary, Kuwait, Austria, the United Kingdom, Ireland, Liechtenstein, France, Japan, New Zealand, Switzerland, Portugal, Spain, the Czech Republic, Malta, Jersey, Malaysia, Mexico, Canada, Italy, Guernsey and Qatar.

The agreements with Liechtenstein, France, Japan and New Zealand, and the Protocol to the Agreement with Luxembourg for the avoidance of double taxation and the prevention of fiscal evasion were gazetted on 13 May 2011.

The agreements with Kuwait, Switzerland and Malta for the avoidance of double taxation were gazetted on 18 May 2012.

The agreements with Jersey and Canada and the second protocol to the agreement with Austria for the avoidance of double taxation were gazetted on 3 May 2013.

The comprehensive double taxation agreement with Portugal came into force on 3 June 2012 and will take effect in Hong Kong starting from the year of assessment 2013/14.

The comprehensive double taxation agreement with Malta came into force on 18 July 2012 and will take effect in Hong Kong starting from the year of assessment 2013/14.

The comprehensive double taxation agreement with Switzerland came into force on 15 October 2012 and will take effect in Hong Kong starting from the year of assessment 2013/14.

The comprehensive double taxation agreement with Malaysia came into force on 28 December 2012 and will take effect in Hong Kong starting from the year of assessment 2013/14.

The comprehensive double taxation agreement with Mexico came into force on 7 March 2013 and will take effect in Hong Kong starting from the year of assessment 2014/15.

A summary of all the comprehensive DTAs are listed in Appendix I.

The salient points of some of the DTAs are discussed in the following section.

5.1 Avoidance of double taxation agreement between the HKSAR and Belgium

On 10 December 2003, the HKSAR signed its first comprehensive agreement ('the Agreement with Belgium') with Belgium on avoidance of double taxation. The Agreement with Belgium entered into force on 7 October 2004. This Agreement covers income tax as well as withholding taxes. Under the agreement, Belgian companies carrying on business in Hong Kong through a permanent establishment will be exempt from paying income taxes at their home country. On the other hand, the amount of tax withheld by the Belgian government on dividends, interest income or royalties payable to HK residents will be reduced.

The Agreement takes effect as follows:

Country	Type of Taxes	Effective from
Belgium	Withholding and capital taxes	On or after 1 January 2004
	Other taxes	Taxable period beginning on or after 1 January 2004
Hong Kong	All taxes	Years of assessment beginning on or after 1 April 2004

The Agreement covers the following:

Withholding taxes

Income	Conditions	Tax Rate
Dividends*	Beneficial owner of dividends: • is a company resident in Hong Kong or Belgium; and • has owned shares representing at least 25% in the payer, without interruption, for at least 12 months.	Nil
	Beneficial owner of dividends: • is a company resident in Hong Kong or Belgium; and • holds directly at least 10% of the capital of the payer.	5%
	Otherwise: Beneficial owner	15%
Interest*	Derived by government body or 'political subdivision' resident in Hong Kong or Belgium	Nil
	Derived by banking enterprises resident in Hong Kong or Belgium on debt claims or loans of any nature, except on bearer instruments	
	Derived by enterprises of Hong Kong or Belgium from deposits with a banking enterprise	
	Derived by a resident of Hong Kong or Belgium in respect of credit extended to cover purchases of goods, merchandise or services	
	Derived in relation to loans (or credit) granted, guaranteed or insured under a scheme organised by a government body, 'political subdivision' or local authority resident in Hong Kong or Belgium to promote exports	
	Otherwise: Beneficial owner or its political subdivisions or local authorities	10%
Royalties	Beneficial owner	5%

* There is no withholding tax in Hong Kong on dividends or interest.

The withholding tax rate generally applicable to royalty payments to non-resident which is a corporation is 4.95% (i.e. deemed profit rate 30% × tax rate 16.5%). Under the Agreement with Belgium, the withholding tax rate on royalty payable to a Belgian resident would be limited to 5% of the gross amount of the royalty. Notwithstanding this withholding rate ceiling, as mentioned in section 3.1.8 above, the deemed profit rate will be 100% (instead of normal rate of 30%) under certain circumstances by virtue of s.21A(1)(a) as an anti-avoidance measure. Article 27 of the Agreement provides that the Agreement shall not prejudice the right of each Contracting Party to apply its domestic anti-avoidance provision. Therefore, notwithstanding the withholding tax rate ceiling in the Agreement, s.21A(1)(a) may apply to make the effective tax rate still at 16.5%.

5.1.1 Capital gains

In general, taxing rights are to lie with the vendor's country of residence. However, taxing rights in respect of gains derived from the sale of immovable property and certain shares in companies that derive at least 50% of their value from immovable property are to lie with the country in which the immovable property is situated: various exemptions apply.

There is no capital gains tax in Hong Kong.

5.1.2 Employment income

Under the Agreement, a resident of one country will not be taxable on income earned in the other country provided that:

- he or she is not present in the source country for a period or periods exceeding in aggregate 183 days in any 12-month period commencing or ending with the taxable period concerned;
- his or her remuneration is not paid by or on behalf of an enterprise resident in the source country;
- the remuneration is not borne by a permanent establishment which the employer has in the source country; and
- his or her remuneration is taxable in the country of residence.

5.1.3 Other provisions

The Agreement also contains:

- an article on the methods for elimination of double taxation; and
- broad 'exchange of information' and 'other income' articles.

Please visit the website of the IRD (**http://www.ird.gov.hk/eng/pdf/dt_belgium.pdf**) for details of the Agreement.

5.2 Avoidance of double taxation agreement between the HKSAR and Thailand

On 7 September 2005, the HKSAR signed a comprehensive Agreement with Thailand ('the Agreement with Thailand') on avoidance of double taxation. The Agreement with Thailand took effect in Hong Kong in respect of Hong Kong tax for any year of assessment beginning on or after 1 April 2006. The Agreement with Thailand would have Hong Kong taxation impact on Thailand residents having income derived from Hong Kong activities or Hong Kong residents.

Under the Agreement with Thailand, business profits of an enterprise of One Side are taxable only in that Side unless the enterprise carries on business in the Other Side through a permanent establishment situated there. Where an enterprise carries on business through a permanent establishment in the Other Side, the enterprise may be taxed in the Other Side but only to the extent that its income is attributable to the permanent establishment.

Income or profits of an enterprise of a contracting party derived in the other contracting party from the operation of ships in international traffic may be taxed in the other contracting party but the tax so charged shall be reduced by an amount equal to 50% thereof.

The withholding tax on dividend shall not exceed 10% of the gross amount of the dividends.
The withholding tax on interest shall not exceed the reduced rates for specified cases (10% - 15%).
The withholding tax on royalties shall not exceed the reduced rates for specified cases (5% to 15%).

The Government of the Hong Kong Special Administrative Region exchanged Notes with the Government of the Kingdom of Thailand to clarify certain issues. After the Agreement became effective, the Hong Kong business sector had doubt whether the profits remitted to a Hong Kong head office by a branch office in Thailand is subject to tax in Thailand. On 21 February 2008, the Hong Kong Special Administrative Region Government replied to the Note from the Thai

Government and confirmed the understanding that either Party shall not impose a tax on profits remitted by a permanent establishment of an enterprise of the Other Party.

The Note from the Thai Government and the Note from the HKSAR Government formed an integral part of the Agreement and entered into force on the date that the Agreement entered into force, that is, 7 December 2005.

5.3 Avoidance of double taxation agreement between the HKSAR and Luxembourg

On 2 November 2007, the HKSAR signed a comprehensive agreement with Luxembourg ('the Agreement with Luxembourg') on the avoidance of double taxation. The Agreement would have Hong Kong taxation impact on residents of Luxembourg having income derived from Hong Kong activities or Hong Kong residents.

The Agreement with Luxembourg took effect in Hong Kong starting from the year of assessment 2008/09. The Specification of Arrangements (Government of the Grand Duchy of Luxembourg) (Avoidance of Double Taxation on Income and Capital and Prevention of Fiscal Evasion) Order 2008 was gazetted on 1 February 2008 and the Order was effective as from 1 April 2008.

Under the Agreement with Luxembourg, business profits of an enterprise of One Side are taxable only in that Side unless the enterprise carries on business in the Other Side through a permanent establishment situated there. Where an enterprise carries on business through a permanent establishment in the Other Side, the enterprise may be taxed in the Other Side but only to the extent that its income is attributable to the permanent establishment.

Income or profits of an enterprise of a contracting party derived in the other contracting party from the operation of ships or aircrafts in international traffic shall only be taxed in that contracting party.

In general, the withholding tax on dividend shall not exceed 10% of the gross amount of the dividends (0% for a corporate owner having 10% or more direct ownership, or participation with an acquisition cost of at least EUR1.2 million in the company paying the dividends). No withholding tax is charged on interest. The withholding tax on royalties shall not exceed 3%.

Hong Kong and Luxembourg signed a Protocol on November 11, 2010 to adopt the 2004 version of the OECD exchange of information article. This order was gazetted on May 13, 2011.

5.4 Avoidance of double taxation agreement between the HKSAR and Vietnam

Hong Kong has signed an Agreement in Hanoi, with Vietnam for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income on December 16, 2008. It is the first bilateral agreement for the avoidance of double taxation signed between the two sides.

The Agreement eliminates the uncertainty of tax liability for the investors and traders of both economies and creates a more favourable bilateral business environment. It will also protect the legitimate tax revenue of both jurisdictions.

The Agreement took effect on August 12, 2009 in respect of Hong Kong tax from the year of assessment 2010/11 onwards.

5.4.1 Definition of resident

As with other double taxation agreements, the Agreement between Vietnam and Hong Kong only applies to residents of Hong Kong or Vietnam. For the purpose of the Agreement, any company or enterprise which is incorporated or constituted under the laws of Hong Kong, or if not incorporated or constituted under the laws of Hong Kong, is nonetheless normally managed or controlled in Hong Kong, will be regarded as being a Hong Kong resident company or enterprise.

An individual who ordinarily resides in Hong Kong or who stays in Hong Kong for more than 180 days during a year of assessment, or for more than 300 days in two consecutive years of

assessment, one of which is the relevant year of assessment, will be considered a Hong Kong resident individual.

5.4.2 Business profits

Active business profits of a Hong Kong resident enterprise will not be liable to tax in Vietnam unless they are attributable to a permanent establishment (PE) maintained by the Hong Kong enterprise in Vietnam.

Article 5 of the Agreement provides a comprehensive definition of PE. Similar to other Hong Kong's DTAs, a PE is defined to include provision of services by an enterprise if the services continue (for the same or connected project) for a period or periods aggregating more than 180 days within any 12-month period.

There is certain exclusion from PE. For example, a Hong Kong resident enterprise will not be liable to tax in Vietnam if it just maintains a buying office in Vietnam which only makes purchases for itself.

5.4.3 Withholding taxes

The Agreement provides limited benefits in withholding tax rates. The following is a comparison of the withholding tax rates for dividends, royalties and interest with and without the Agreement:

	Dividends	Royalties	Interest
Treaty rate	10% (a)	7%/10% (b)	0%/10% (c)
Hong Kong non-treaty rate	Nil	4.95%/4.5% (d)	Nil
Vietnam non-treaty rate	Nil	10%	10%

Notes:

(a) Currently, there is no withholding tax on dividends in Vietnam after tax is paid on the profits out of which the dividends are declared. The 10% treaty rate represents the maximum rate applicable to dividends received by a Hong Kong resident should a withholding tax on dividends be levied in Vietnam in the future.

(b) The 7% rate applies to royalties for the use, or right to use, any patent, design or model, plan, secret formula or process. The 10% rate applies to all other cases.

(c) The 0% rate applies to interest payments to the Hong Kong SAR Government and recognised institutions. The 10% rate applies to all other cases.

(d) The 4.95% rate applies to corporations whereas the 4.5% rate applies to unincorporated businesses.

5.4.4 Capital gain

The Agreement offers tax exemption to capital gains derived by a Hong Kong resident from the alienation of less than 15% interest in a Vietnamese company that does not derive 50% or more of its asset value directly or indirectly from immovable property situated in Vietnam.

5.4.5 Employment income

Hong Kong employees will be exempted from Vietnamese personal income tax provided that:

(1) they do not spend more than 183 days in Vietnam in any 12-month period commencing or ending in the fiscal year concerned;

(2) their remuneration is paid by, or on behalf of, an employer who is not a resident of Vietnam; and

(3) the remuneration is not borne by a PE the employer has in Vietnam.

5.4.6 Transfer pricing adjustment

Article 9 empowers tax authorities of both sides to make necessary adjustments if transactions between 'associated enterprises' are not at arm's length.

5.4.7 Avoidance of double taxation

Where the income of a Hong Kong resident is subject to tax in both Vietnam and Hong Kong, the Hong Kong resident may credit the tax paid in Vietnam on the relevant income against the Hong Kong tax liability charged on the same income. The tax credit available is, however, limited to Hong Kong tax charged on the same income. The same tax credit mechanism also applies to relieve double taxation of a Vietnam resident being taxed in both sides.

5.4.8 Exchange of information

The Exchange of Information clause adopted is the more restrictive 1995 OECD-version, which restricts the exchange of information to that required in order to carry out the provisions of the agreement or the domestic laws of each other concerning the taxes covered by the agreement. Furthermore, Hong Kong is not obliged to supply any information to Vietnam if the information sought is not obtainable under the tax laws of Hong Kong or by way of normal administrative practice in Hong Kong. Negotiations are in progress to update the EoI article this treaty.

5.5 Avoidance of double taxation agreement between the HKSAR and the Netherlands

On 22 March 2010, Hong Kong and the Netherlands entered into a full comprehensive double taxation agreement.

5.5.1 Definition of resident

Same as other double taxation agreements, the agreement between the Netherlands and Hong Kong only applies to residents of Hong Kong or the Netherlands. For the purpose of the Agreement, any company or enterprise which is incorporated or constituted under the laws of Hong Kong, or if not incorporated or constituted under the laws of Hong Kong, is nonetheless normally managed or controlled in Hong Kong, will be regarded as being a Hong Kong resident company or enterprise.

An individual who ordinarily resides in Hong Kong or who stays in Hong Kong for more than 180 days during a year of assessment, or for more than 300 days in two consecutive years of assessment, one of which is the relevant year of assessment, will be considered a Hong Kong resident individual.

5.5.2 Business profits

Active business profits of a Hong Kong resident enterprise will not be liable to tax in the Netherlands unless they are attributable to a permanent establishment (PE) maintained by the Hong Kong enterprise in the Netherlands, The DTA between Hong Kong and the Netherlands came into force on 24 October 2011. This DTA took effect from 1 April 2012 in Hong Kong.

Similar to other Hong Kong's CDTAs, a PE is defined to include provision of services by an enterprise if the services continue (for the same or connected project) for a period or periods aggregating more than 183 days in any 12-month period. Again, there are certain exclusions from PE like other CDTAs.

5.5.3 Withholding taxes

The agreement provides limited benefits in withholding tax rates. The following is a comparison of the withholding tax rates for dividends, royalties and interest with and without the agreement:

	Dividends	Royalties	Interest
Treaty rate	0%/10% (a)	3% (b)	0% (c)
Hong Kong non-treaty rate	Nil	4.95%/4.5% (d)	Nil (c)
Netherlands non-treaty rate	15%	0%	0%

Notes:

(a) The current withholding tax rate in the Netherlands is 15%. Article 10 of the tax agreement provides that the withholding tax on dividends paid by a Dutch resident company to a Hong Kong resident shall not exceed 10% of the gross amount of the dividends. In addition, Article 10 provides for a full exemption of taxation in the Netherlands on dividends paid by a Dutch resident company, if the beneficial owner of the dividends is:

(1) A company, other than a partnership, which is a resident of Hong Kong and holds directly at least 10% of the capital of the company paying the dividends, provided that

(i) The shares of the company receiving the dividends are regularly traded on a recognised stock exchange or

(ii) At least 50% of the shares of the company receiving the dividends are owned by a company, the shares of which are regularly traded on a recognised stock exchange, provided the last mentioned company is

- a resident of either the Netherlands or Hong Kong, or
- a resident of a member State of the European Union and that company would be entitled to similar or more favourable benefits as provided by this article pursuant to a comprehensive arrangement for the avoidance of double taxation between its State of residence and the Netherlands, or pursuant to a multilateral agreement to which its State of residence and the Netherlands are a party

(2) a Hong Kong resident bank or insurance company that is established and regulated as such under the laws of Hong Kong; or

(3) a headquarters company of a multilateral corporate group which provides a substantial portion of the overall supervision and administration of the group and which has, and exercise, independent discretionary authority to carry out these functions; or

(4) a pension fund or scheme of Hong Kong provided that the qualifying conditions are met; or

(5) the Hong Kong government and certain qualifying parts or entities of the Hong Kong government; or

(6) a company other than a company mentioned above provided that the competent authority of the Netherlands determines that the establishment, acquisition or maintenance of the company does not have its main purpose or one of its main purposes to secure the benefits of this article.

(b) No royalty withholding tax is levied in the Netherlands currently. Under the tax agreement, royalties arising in Hong Kong received by a Dutch resident will be subject to a reduced withholding tax rate of 3% in Hong Kong.

(c) There is no interest withholding tax under the domestic law of Hong Kong or the Netherlands.

(d) The 4.95% rate applies to corporations whereas the 4.5% rate applies to unincorporated businesses.

5.5.4 Capital gain

Capital gain on disposal of shares derived by a Hong Kong resident investor, other than those from the alienation of shares of a Dutch company (i) which has 50% or more of its asset value comprising, directly or indirectly, of immovable property located in the Netherlands; and (ii) of which the Hong Kong resident investor holds directly or indirectly a minimum of 5% of its issued shares, would not be chargeable to tax in the Netherlands.

The exemption from capital gain tax in the Netherlands is still available if:

(i) the shares being disposed of are quoted on an agreed stock exchange or

(ii) the shares are disposed of within the framework of a reorganisation of such company, a merger, a scission or a similar operation or

(iii) the business of such company is carried on in the immovable property in question.

5.5.5 Employment income

Hong Kong employees will be exempted from Dutch personal income tax provided that:

(1) they do not spend more than 183 days in the Netherlands in any 12-month period commencing or ending in the fiscal year concerned;

(2) their remuneration is paid by, or on behalf of, an employer who is not a resident of the Netherlands and

(3) the remuneration is not borne by a PE which the employer has in the Netherlands.

5.5.6 Transfer pricing adjustment

Article 9 empowers tax authorities of both sides to make necessary adjustments if transactions between 'associated enterprises' are not at arm's length.

5.5.7 Avoidance of double taxation

Where the income of a Hong Kong resident is subject to tax in both the Netherlands and Hong Kong, the Hong Kong resident may credit the tax paid in the Netherlands on the relevant income against the Hong Kong tax liability charged on the same income. The tax credit available is, however, limited to Hong Kong tax charged on the same income. The same tax credit mechanism also applies to relieve double taxation of a Dutch resident being taxed in both sides.

5.5.8 Exchange of information

The tax agreement is the first agreement with an EU member that has adopted the 2004 version of the OECD exchange of information article (EoI). The 2004 version is wider in scope than the 1995 version of the EoI article previously adopted in Hong Kong's tax agreements with five other jurisdictions.

5.5.9 Entry into force

The provisions of the tax agreement shall have effect:

(a) for Hong Kong, for any year of assessment beginning on or after 1 April 2012
(b) for the Netherlands, for any taxable year and periods beginning on or after 1 January 2012.

5.6 Other double taxation agreements

As of 1 June 2013, Hong Kong has signed 29 DTAs with other jurisdictions.

The provisions contained in these agreements are similar.

For profits derived from business activities, a Hong Kong resident enterprise will not be subject to income tax in other contracting state if it does not carry on business in other contracting state through a permanent establishment. The definition of permanent establishment is slightly different for different CDTAs. For example, the furnishing of services by a Hong Kong resident enterprise in Switzerland will amount to a permanent establishment in Switzerland if the servicing period in

aggregate is more than 270 days within any 12 month period. Dividends, interest and royalties received by a Hong Kong resident from a resident of other Contracting State may be subject to reduced withholding tax rates which vary amongst the countries. Capital gains tax may be exempted in other Contracting States for alienation of shares in a resident company of other contracting state by a Hong Kong resident investor if conditions are met. Double taxation may be eliminated by way of tax credit in Hong Kong. EoI article of these newly signed agreements are based on the 2004 version of OECD's Model Tax Treaty.

Please refer to Appendix 1 for a summary of the CDTAs that Hong Kong has signed as of 1 June 2013.

Appendix 1

Summary of Avoidance of Double Taxation Agreements

DTA with Hong Kong	Withholding tax charged by the host country			Taxing right of the host country		Taxing right of capital gain on disposal of shares of	
	Dividend	Interest	Royalty	Shipping income	Airline income	Company's assets >50% are immovable property	Other companies
PRC	5%[(i)]/ 10%	7%	7%	Exempted	Exempted	Both home country and host country	< 25% shareholding – home country, others – both
Belgium	0%[(ii)]/ 5%[(iii)]/ 15%	10%	5%	Exempted	Exempted	Both, except quoted shares, reorganisation, property dealing business	home country
Thailand	10%	10%[(iv)]/ 15%	5%[(v)]/ 10%[(vi)]/ 15%	50% reduction	Exempted	Both	home country
Luxembourg	0%[(iii)]/ 10%	0%	3%	Exempted	Exempted	Both, except quoted shares, reorganisation, property dealing business	home country
Vietnam	10%	10%	7% [(vii)]/ 10%	Exempted	Exempted	Both	< 15% shareholding – home country, others – both
Netherlands	0%/10%[(viii)]	0%	3%	50% reduction	Exempted	Both, except quoted shares, reorganisation, property dealing business	<5% shareholding – home country, others – both
Indonesia	5%[(i)]/10%	10%	5%	50% reduction	Exempted	Both, except quoted shares, reorganisation, property dealing business	Home country
Brunei	0%	5%/10%[(ix)]	5%	Exempted	Exempted	Both, except quoted shares, reorganisation, property dealing business	Home country

DTA with Hong Kong	Withholding tax charged by the host country			Taxing right of the host country		Taxing right of capital gain on disposal of shares of	
	Dividend	Interest	Royalty	Shipping income	Airline income	Company's assets >50% are immovable property	Other companies
Hungary	0%/10%[(x)]	0%/5%	0%/5%	Exempted	Exempted	Both, except quoted shares, reorganisation, property dealing business	Home country
Kuwait	0%/5%[(xi)]	0%/5%	5%	Exempted	Exempted	Both, except quoted shares, reorganisation, property dealing business	Home country
Austria	0%/10%[(xii)]	0%	3%	Exempted	Exempted	Both, except quoted shares, reorganisation, property dealing business	Home country
United Kingdom	0%/15%[(xiii)]	0%[(xiv)]	3%	Exempted	Exempted	Both, except quoted shares, reorganisation, property dealing business	Home country
Ireland	0%	0%/10%[(xv)]	3%	Exempted	Exempted	Both, except quoted shares	Home country
Liechtenstein	0%	0%	3%	Exempted	Exempted	Both, except quoted shares	Home country
France	10%	0%/10%[(xvi)]	10%	Exempted	Exempted	Both, except quoted shares	Home country
Japan	5%/10%[(xvi)]	0%/10%[(xvi)]	5%	Exempted	Exempted	Both, except quoted shares	Home country
New Zealand	5%/15%[(xvi)]	10%	5%	Exempted	Exempted	Both, except quoted shares	Home country
Switzerland	0%/10%[(xvi)]	0%	3%	Exempted	Exempted	Both, except quoted shares	Home country
Portugal	5%/10%[(xvi)]	10%	5%	Exempted	Exempted	Both	Home country
Spain	0%/10%[(xvi)]	5%	5%	Exempted	Exempted	Both, except quoted shares	Home country

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Czech Republic	5%	0%	10%	Exempted	Exempted	Both, except quoted shares	Home country
Malta	0%	0%	3%	Exempted	Exempted	Both, except quoted shares	Home country
Jersey	0%	0%	4%	Exempted	Exempted	Both, except quoted shares	Home country
Malaysia	5%/10%(xvi)	10%	8%	Exempted	Exempted	Both, except quoted shares	Home country
Mexico	0%	0%/4.9%/ 10%(xvi)	10%	Exempted	Exempted	Both, except reorganisation	Home country
Canada	5%/15%(xvi)	10%	10%	Exempted	Exempted	Both	Home country
Italy	10%	12.5%	15%	Exempted	Exempted	Both, except quoted shares	Home country
Guernsey	0%	0%	0%	Exempted	Exempted	Both, except quoted shares and reorganisation	Home country
Qatar	0%	0%	5%	Exempted	Exempted	Both, except quoted shares, reorganisation and property dealing business	Home country

(i) Corporate shareholders having direct ownership of at least 25% of the capital.

(ii) Corporate shareholders having direct ownership of at least 25% of the capital for an uninterrupted period of 12 months.

(iii) Corporate shareholders having direct ownership of at least 10% of the capital.

(iv) Derived by beneficial owner who is a financial institution; or a resident of the other contracting party for indebtedness arising as a consequence of a sale on credit by a resident of that other Contracting Party of any equipment, merchandise or services at arm's length.

(v) For the use of, or the right to use, any copyright of literary, artistic or scientific work.

(vi) For the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process.

(vii) For the use of, or the right to use, any patent, design or model, plan, secret formula or process

(viii) Corporate listed shareholders having direct ownership of at least 10% of the capital, other cases at 10%.

(ix) 5% if received by banks or financial institutions, other cases at 10%.

(x) Currently, under the domestic law of Hungary, no withholding tax is imposed on dividends paid to non-resident corporate recipients, whereas a withholding rate of 25% is applicable to

non-resident individual recipients. Under the Hong Kong-Hungary CDTA the applicable withholding rate for non-resident individual recipients will be reduced to 10%.

(xi) 0% applies if the recipient is the Hong Kong Government or certain qualifying entities of the Hong Kong Government. For other cases, 5% applies.

(xii) 0% applies for recipient which is a Hong Kong resident company (other than a partnership) and holds directly at least 10% of the capital of the dividend paying company. 10% applies for other cases.

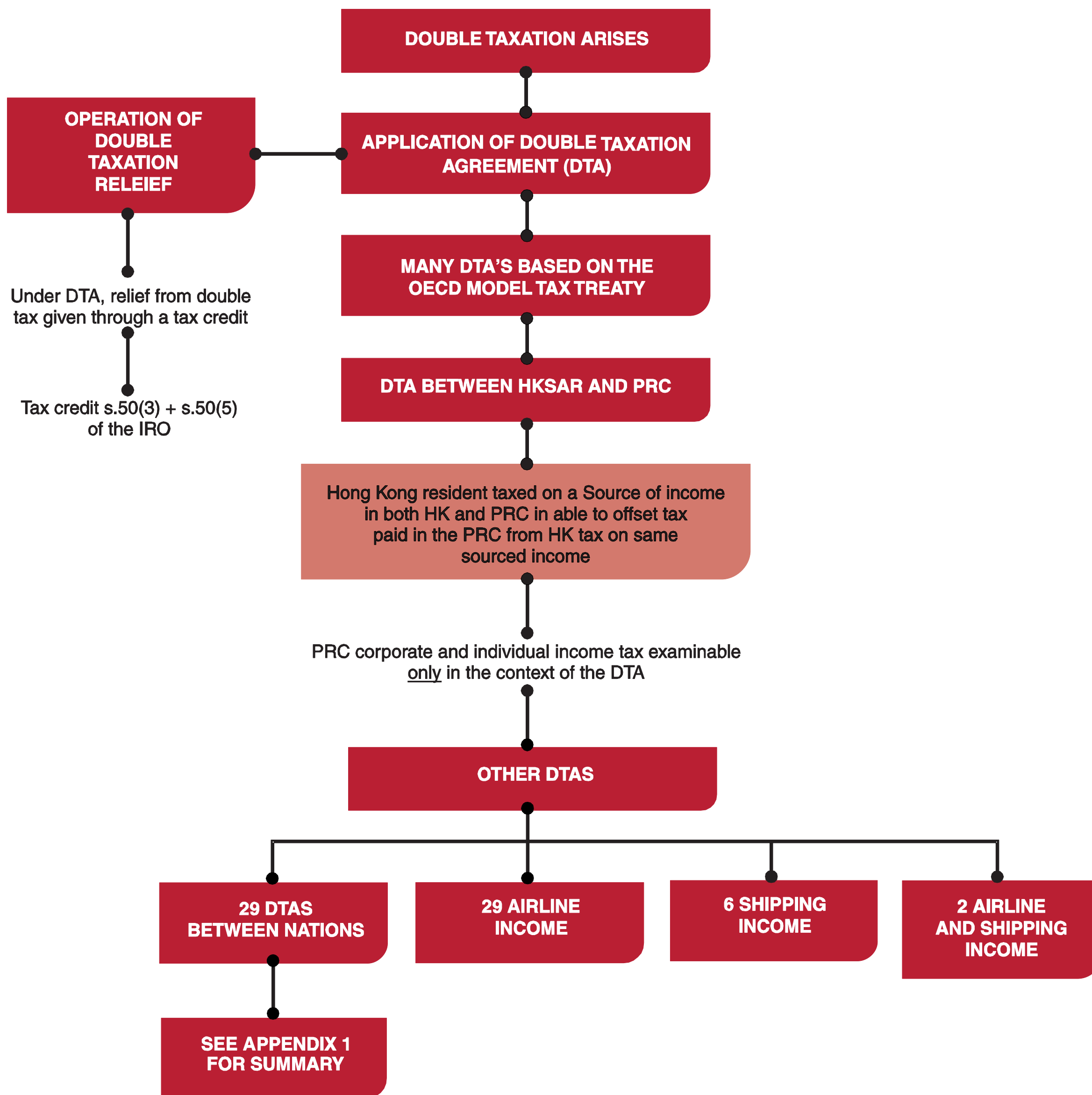
(xiii) 15% applies to dividends paid by Real Estate Investment Trusts.

(xiv) Subject to provision to ensure the benefits only flow to residents of the other state.

(xv) 0% applies to recipient which is Hong Kong Government or the Hong Kong Monetary Authority or a statutory body, institution or fund wholly or mainly owned or appointed by the Hong Kong Government. 10% applies for other cases.

(xvi) Provided the conditions are satisfied as stipulated in the respective double taxation agreements.

Topic recap



Answer to self-test question

Answer 1

By s.14(1) of the IRO, there is no doubt that the first two conditions are satisfied: the Firm carries on business in Hong Kong and derives profits from that business. It follows that the key issue for determination is whether the Firm's profits arise in, or are derived from, a source in Hong Kong.

To determine the source of profits for the Firm the broad guiding principles set out in *Hang Seng Bank* and *HK-TVB* should be applied. These principles are: what activities take place to derive the profits in dispute? And where did these activities take place?

As this is a case involving payment for services, the relevant activities are the actual services the Firm provides for the payment it receives. The Firm's profits from carrying out services arise where those services are performed: see *Hang Seng Bank* (see further DIPN 21). *Prima facie,* this took place both in Hong Kong and in the Mainland.

Using the broad guiding principles it is clear only the activity of the taxpayer and, where relevant, its authorised agents should be examined: *Wardley*. Was the local law firm an agent of the Firm? Does this matter? The Board of Review decision in *D71/97* seems to indicate, because source of profits is a hard, practical matter of fact, that such fine distinctions in cases such as this may not be decisive in determining the source of profits. If this conclusion is correct, it seems that the activities of the Shanghai law firm should be taken into account as part of the matrix of activities necessary for the Firm to derive its profits.

If, as appears very likely, there are significant Hong Kong as well as Mainland activities giving rise to the Firm's profits, is there any possibility of apportionment between Hong Kong and Mainland-sourced profits? The answer is yes, because under DIPN 21 service income is one category where apportionment is allowed (*Hang Seng Bank*). Typically this is allowed on a 50/50 basis. More information is required before finalising any advice as to source of profits and the method of apportionment appropriate in this case. This information includes:

(a) full documentation relating to the service contract,

(b) a complete list of all activities carried on in/outside Hong Kong to derive the profits, as well as the related costs, and

(c) the Firm's tax position in the Mainland.

Point (c) above relates to the potential application of the Mainland-HK Arrangement for the Avoidance of Double Taxation (see further DIPN 44). Although the concept of a traditional representative office is excluded from the definition of permanent establishment, it appears that the operations of the Firm in Shanghai go well beyond the permitted exempted categories of collecting information or carrying out other activities of a preliminary or auxiliary character for the Firm. This crucial definition determines the jurisdiction to tax a HK resident by the Mainland SAT, and *vice versa*.

If the representative office exemption does not apply, and the Firm does have a permanent establishment in the Mainland, the profits attributable to that permanent establishment would not be taxable in Hong Kong. The most likely basis for this conclusion would be that those profits are simply not derived in Hong Kong (see analysis above). But, in any event, those profits would attract a tax credit in Hong Kong if, in the less likely case, they arose from a source in Hong Kong but were nonetheless subject to income tax in the Mainland (Article 21 of CDTA – DIPN 44).

Exam practice

Blue Hero Consultancy Ltd — 36 minutes

Blue Hero Consultancy Ltd ('BHC') is incorporated in Hong Kong and was engaged by a PRC company to provide training services. While BHC rendered the majority of the training services in Hong Kong, it did provide some services in the Mainland. In this regard, it has sent three training managers to work in Beijing and the services-rendering period was from 1 September 2007 to 1 March 2008. The PRC company paid a consultancy fee to BHC for the services rendered. As most of the services were rendered in Hong Kong, BHC returned all services fee as assessable to Hong Kong Profits Tax.

Required

(a) Briefly explain whether BHC's activities in the Mainland will be regarded as a 'permanent establishment' and hence it will be subject to Income Tax in the Mainland. Also briefly explain the Individual Income Tax position of BHC's employees working for the project in the Mainland. **(12 marks)**

(b) If the service-rendering period is from 1 September 2008 to 1 March 2009, briefly explain the Income Tax position of BHC and its employees working for the project in the Mainland. **(4 marks)**

(c) Assume BHC has been treated as a having a 'permanent establishment' in the Mainland in respect of the services rendered there and therefore BHC has paid Income Tax in the Mainland for the profits attributable to that permanent establishment. BHC has also paid Business Tax that was charged based on the gross amount of the consultancy fee received. Briefly explain the relief that may be available to BHC. **(4 marks)**

(Total = 20 marks)

B Limited

27 minutes

B Limited is an electronics manufacturer in Taiwan. At the relevant times, there was a restriction imposed on Taiwan enterprises whereby they could not deal with their counterparts in Mainland China ('the Mainland') directly. In order to circumvent such trade barriers, B Limited established a wholly-owned subsidiary, C Limited, in Hong Kong and, through which, subcontracted part of the manufacturing process to a factory in the Mainland ('the Mainland Factory') by way of import processing. The Mainland Factory is a foreign investment enterprise in which 60% of the shares were held by C Limited. All along B Limited was the only customer of C Limited. It supplied, through C Limited, all the required raw materials and technology to the Mainland Factory. For the sake of quality assurance, B Limited also seconded a number of engineers from Taiwan to the Mainland to supervise the manufacturing process undertaken by the Mainland Factory. In Hong Kong, C Limited neither had any staff nor a permanent office. It engaged a secretarial company to handle various tasks such as receipt and issue of invoices, transshipment of raw materials and the semi-finished parts, customs declaration and account settlement on its behalf and under its instructions. It resold the parts to B Limited at a mark-up of 2%, which resulted in minimal profits to C Limited after deducting the service fees paid to the secretarial company.

C Limited claimed that all of its profits were derived offshore as the semi-finished parts were produced in the Mainland, and it did not have any office nor staff in Hong Kong. The offshore claim is now being reviewed by the Assessor. Further, the Assessor also queried whether the mark-up charged on B Limited satisfied the arm's length principle.

Required

Assuming that you are appointed as the tax representative of C Limited,

(a) evaluate the offshore claim lodged by C Limited (**Note:** The evaluation should cover both the arguments for and against the offshore claim); and **(10 marks)**

(b) discuss how you should address the arm's length issue raised by the Assessor and the transfer pricing methodologies that you may adopt in this connection. **(5 marks)**

(Total = 15 marks)

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Further reading

Suggested References

When studying this topic we suggest the following references:

Primary References

Advanced Taxation in Hong Kong, Pearson (Chapter 23 – Taxation of Overseas Activities)

Hong Kong Master Tax Guide, CCH Hong Kong Ltd (Chapter 8 – Double Taxation Relief)

Hong Kong Taxation – Law & Practice, The Chinese University Press (Chapter 11 – Double Taxation)

Hong Kong Taxation and Tax Planning, Pilot Publishing Co Ltd (Chapters 34, 45 and 46)

Inland Revenue Ordinance (Part VIII)

DIPN 32 Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the avoidance of double taxation on income

DIPN 44 (Revised) Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income

DIPN 45 Relief from double taxation due to transfer pricing or profit reallocation adjustments

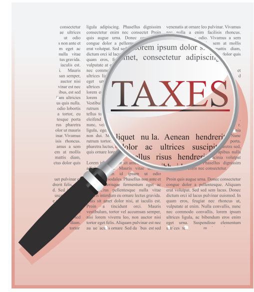
DIPN 46 Transfer pricing guidelines - Methodologies and related issues

DIPN 47 Exchange of information under comprehensive double taxation agreements

DIPN 48 Advance Pricing Arrangement

Supplementary Reference

Hong Kong Tax Manual, CCH Hong Kong Ltd (Para 15 – Profits Tax)



Part G

China tax system

With the growth of cross border transactions, it is increasingly important to obtain an awareness of the China tax system. The turnover taxes are different from the typical Hong Kong taxes. Students should acquire sufficient understanding for the three important turnover taxes: business tax, consumption tax and value-added tax.

chapter 13

Overview of China tax system

Topic list

1 The tax administration system in China
- 1.1 Introduction

2 Duties of tax bureaus
- 2.1 Structure of tax authority
- 2.2 Tax collection and administration

3 System for tax collection
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4 Tax disputes and appeals
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5 Business tax
- 5.1 Taxable scope
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6 Business tax rate and calculation
- 6.1 Tax rate
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7 Payment of Business Tax
- 7.1 Timing of tax liability
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8 Introduction to Value Added Tax
- 8.1 Basic principle of tax computation
- 8.2 VA payable and input credit
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9 The scope of VAT
- 9.1 Scope of VAT
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10 VAT taxpayer
- 10.1 General taxpayer and small-scale taxpayer

11 VAT tax rate
- 11.1 Reduced VAT rates
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- 11.3 Zero rate
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- 11.5 Import VAT calculation

12 VAT exemptions
- 12.1 Exemptions

13 Payment of VAT
- 13.1 Timing of tax liability
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- 13.3 Tax periods
- 13.4 VAT Group

14 VAT Reform Pilot Programme

15 Introduction to consumption tax
- 15.1 The concept of consumption tax

16 Consumption tax taxable scopes and tax rate

17 Consumption tax taxpayers

18 Calculation of consumption tax liability
- 18.1 *Ad valorem* fixed rate method

19 Consumption tax relief and tax refund on exports
- 19.1 Tax abatement
- 19.2 Consumption tax refund

20 Payment of Consumption Tax
- 20.1 Timing of tax liability
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21 Individual Income Tax
- 21.1 Tax resident
- 21.2 Source of income
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- 21.6 Senior Management
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22 Corporate Income Tax
- 22.1 Tax resident
- 22.2 Corporate Income Tax Computation
- 22.3 Tax administration
- 22.4 Transfer pricing

Learning focus

In addition to having a broad knowledge of Hong Kong tax law, Hong Kong accountants should also have a basic awareness of the China tax system and the major types of taxes in China. We discuss the three turnover taxes in China, namely Business Tax, Value Added Tax and Consumption Tax.

PRC Corporate Income Tax and Individual Income Tax are discussed in this chapter and also covered in the context of the Double Taxation Arrangement between the Mainland and the HKSAR in chapter 12.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Understand the key aspects of the tax system in China		
4.01	**Overview of China tax system**	1
4.01.01	Outline the China tax system	
4.01.02	Outline the regimes of VAT, consumption tax and business tax in China	
4.01.03	Outline the regime of Individual Income Tax	
4.01.04	Outline the regime of Corporate Income Tax	

1 The tax administration system in China

Topic highlights

The supreme authority to make and interpret tax legislation is vested in the National People's Congress and its Standing Committee, in accordance with The Constitution of the People's Republic of China.

1.1 Introduction

In the Mainland, there are 24 types of taxes which are classified under seven categories: turnover tax, income tax, resource tax, property and behaviour taxes, agriculture tax, customs duty and tax on prescribed items.

The legislative and administrative rights of tax laws in the Mainland are vested in various bodies:

(a) The supreme authority to make and interpret tax legislation is vested in the National People's Congress and its Standing committee, in accordance with The Constitution of the People's Republic of China.

(b) As delegated by the National People's Congress and its Standing Committee, the State Council and State Administration of Tax can make administrative regulations like 'regulations', 'provisions', and 'measures' and 'detailed rules for implementation' etc. to administer the tax legislations.

(c) The Provincial People's Congress and its Standing committee have the right to make local rules and regulations, provided that they do not contravene the Constitution of the People's Republic of China, or laws made by the National People's Congress, or the administrative regulations made by the State Council.

(d) In some large cities, autonomous regions and cities where the Special Economic Zones are located, the People's Government in these jurisdictions are also empowered to make provisions and measures.

2 Duties of tax bureaus

Topic highlights

The State Administration of Taxation (SAT) is responsible for formulating and co-ordinating tax policies and supervising the work of local tax bureaus at provincial and municipal levels. There are also local state tax bureaus which handle the day to day administration of central taxes and shared taxes. Local tax bureaus handle the local taxes.

2.1 Structure of tax authority

State tax authorities include state tax authorities of provinces, autonomous region, municipalities directly under the Central Government, state tax authorities of regional, prefecture-level city, autonomous regions, league (Mongolia); State tax authorities of county, county-level city, banner (Mongolia) and their sub-bureaus.

Local tax authorities include local tax authorities of provinces, autonomous regions, municipalities directly under the Central Government, local tax authorities of regional, prefecture-level city, autonomous region, league; local tax authorities of county, county-level city, banner and their sub-bureaus.

2.2 Tax collection and administration

The state tax authorities are responsible for the administration and collection of taxes that generate revenue for the central government or revenue which is shared between the central and local governments, Major types of taxes collected by the state tax bureaus include value added tax, consumption tax, vehicle purchase tax, corporate income taxes, etc.

The local tax authorities are responsible for the administration and collection of the taxes that only generate revenue for the respective local governments. Major types of taxes collected by the local tax bureaus include business tax, urban maintenance and construction tax, individual income tax, resource tax, land appreciation tax, property tax, vehicle and vessel usage tax, stamp duty, deed tax, etc.

There has been an information exchange mechanism between the PRC tax bureau and the PRC local industry and commerce bureau to exchange information about the registration, change in registration and deregistration of enterprises.

In recent years, the PRC tax authorities have put more emphasis on tax collection from non-resident enterprises such as withholding tax on capital gain and from foreign investment enterprises. They no longer rely solely on voluntary filings and reports submitted by the taxpayers. The PRC tax authorities can seek publicly available information in respect of offshore direct and indirect transfers.

3 System for tax collection

Topic highlights

The State Council has designated the SAT to be responsible for collection and administration of central taxes and shared taxes. Local tax bureaus collect local taxes for the respective local governments.

3.1 System for tax deferral

A taxpayer or a withholding agent must hand over the tax payment within the prescribed time limit. However, a taxpayer under particular difficulties may be allowed to postpone the tax payment for a maximum of three months with the approval of the state tax bureau or local tax bureau of a province, autonomous region and municipality directly under the State Council (*Administrative Law on Levying and Collection of Taxes (ALLCT), Art 31*)

Such special 'difficulties' may include considerable damage that is caused by *force majeure*, hence severely affecting the normal production and business activities; insufficient current monetary funds to pay the tax after paying wages owed to employees and social insurances (*Regulations on Implementation of Administration of Tax Collection (RIATC), Art 41)*

3.2 Surcharge for tax payment

A taxpayer failing to pay tax or a withholding agent failing to deliver the tax payment within the prescribed time limit may be subject to heavy penalties. The taxpayer can be ordered by the tax authorities to pay or hand over the tax before the deadline, and pay a daily surcharge on the overdue part at 0.05% of the tax underpayment counting from the day of deferral (*ALLCT, Art 32*).

In the event that a taxpayer or a withholding agent has not paid or has underpaid tax owing to a mistake on the part of the tax authorities, the tax authorities may ask the taxpayer or the withholding agent to pay the tax within three years but no surcharge shall be imposed on the underpayment (*ALLCT, Art 52*).

However, if the failure to levy the tax partially or entirely is caused by fault in calculation or the mistake of the taxpayer, the tax authorities may seek recourse for the tax payment plus a

surcharge for the underpayment within three years; and the term for recourse for underpayment may be prolonged to five years in special circumstances.

In addition to the overdue tax surcharge, depending on the reason for non-payment or under-payment of taxes, the tax authorities can impose a non-compliance penalty ranges from 50% to 500% of tax unpaid or underpaid.

Where the under-payment of tax constituted a criminal offence, the taxpayer will be prosecuted for criminal liability in accordance with the relevant laws.

There is no time limit for tax authorities to demand payment of unpaid, underpaid tax and surcharge for overdue tax payment resulting from tax evasion or fraud.

3.3 Tax refunds

Where a taxpayer has overpaid tax, the tax authorities should immediately refund upon discovery the excess payment. If the mistake is discovered within three years after the settlement of the tax payment, the taxpayer may make claim to the tax authorities for the excess payment plus the interest at the rate of a bank deposit of the same term (*ALLCT, Art 51*). There is no time limitation where the tax authorities discover the overpayment.

4 Tax disputes and appeals

Topic highlights

Tax administrative review and tax administrative prosecution both deal with tax disputes concerning tax administration, but their proceedings are different.

4.1 Tax administrative review

Tax administrative review may be instigated by any of the parties (taxpayer, withholding agent or tax payment guarantor). When they believe that the tax specific administrative actions made by tax authorities and their staff infringe upon their legitimate rights and interests, they may make objection by applying to the tax authorities at a higher level or local people's governments for reconsideration in conformity with the law. The department responsible for reconsideration would then make a decision to maintain, change, or revoke the tax specific administrative actions made by the original tax authorities.

4.2 The scope of tax administrative review

"Taxation Administrative Review Regulations" (TARR) [2010] No. 21 was issued by the State Administration of Taxation on 10 February 2010. The Review Regulations became effective from 1 April 2010.

The scope of tax administrative review is specified as under Article 14 of the Review Regulations

(a) Collection made by tax authority
   (i) To collect taxes and add surcharge for underpayment
   (ii) To withhold and remit tax or collect and remit tax through withholding agents authorised by tax authorities

(b) Order made by tax authority to the taxpayer to provide a guarantee for tax payment.

(c) Measure made by tax authorities to retain tax revenue.

(d) Failure on the part of the tax authorities to lift measures for retaining tax revenue immediately where the legitimate interests of a taxpayer are jeopardised.

(e) Tax mandatory enforcement measures made by tax authority.